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NONDISCRIMINATION RULES APPLICABLE TO EMPLOYEE BENEFIT PLANS UNDER SECTION 89 OF THE INTERNAL REVENUE CODE

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

H.R. 1864

TO AMEND THE INTERNAL REVENUE CODE OF 1986 TO SIMPLIFY THE ANTIDISCRIMINATION RULES APPLICABLE TO CERTAIN EMPLOYEE BENEFIT PLANS

MAY 2 AND 3, 1989

Serial 101–43

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TO SIMPLIFY THE NONDISCRIMINATION RULES APPLICABLE TO EMPLOYEE BENEFIT PLANS UNDER SECTION 89 OF THE INTERNAL REVENUE CODE

TUESDAY, MAY 2, 1989

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 11:06 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearings and a copy of the bill, H.R. 1864, follow:]

FOR IMMEDIATE RELEASE -
FRIDAY, APRIL 14, 1989

corrected
version

PRESS RELEASE #14
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES INTRODUCTION OF, AND A PUBLIC HEARING ON, H.R. 1864, A BILL TO SIMPLIFY THE NONDISCRIMINATION RULES APPLICABLE TO EMPLOYEE BENEFIT PLANS UNDER SECTION 89 OF THE INTERNAL REVENUE CODE

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that he has introduced, along with the Honorable Thomas Foley, Majority Leader of the House, and 28 Members of the Committee on Ways and Means, H.R. 1864, a bill to simplify the nondiscrimination rules applicable to employee benefit plans under Section 89 of the Internal Revenue Code. In addition, Chairman Rostenkowski announced that the Committee on Ways and Means will hold a public hearing on this bill on Tuesday, May 2, 1989, beginning at 10:00 a.m., in the Committee's main hearing room, 1100 Longworth House Office Building.

In announcing the introduction of the bill and this hearing, Chairman Rostenkowski stated: "I am introducing a bill to significantly simplify the nondiscrimination rules of Section 89. This bill is designed to address the concerns raised by employers about the complexity of Section 89 under present law, but without retreating from the fundamental policy objectives of the Tax Reform Act of 1986. This bill promotes the broad health care coverage of rank-and-file employees. It also limits the amount of tax-sheltered health benefits that may be received by highly-paid employees in situations where significantly less generous coverage is made available to nonhighly-paid employees.

"The tax revenue lost to the Treasury because of the exclusion for employer-provided health insurance will exceed $32 billion in fiscal year 1990 alone. I think it is only appropriate to retain rules that ensure that this significant tax subsidy is available only to employer health insurance programs that promote broad-based health coverage, rather than coverage of only highly-paid employees or executives.

"However, the bill I am introducing accomplishes its objectives while eliminating most of the complexity of present law Section 89. This bill replaces the current complexity of alternative tests and safe harbors with a single, simplified test. This is a design-based test. That is, if an employer chooses, no data collection is necessary, and an employer can tell if his health program passes the test at the beginning of the year merely by scrutinizing the design of its plan. In fact, we expect that many employers would choose to buy prototype plans based on the design provided in the statute to ensure that their plans pass, with no employer testing required.

"Under the bill, if an employer's health program is to receive favorable tax treatment, the employer must make available to 90 percent of his rank-and-file employees at least one affordable health plan. For this purpose, an affordable health plan is a plan with a maximum employee premium of $10 per week for individual coverage, and $25 per week for family coverage. This is an availability test only; it is not required that the employer collect data to figure out how many rank-and-file employees actually take such coverage.

"There is no minimum employer contribution specified in this availability test. The employer is free to supplement the employee premium with any additional premium. Also, of course, the employer may make available a broad array of additional health coverage. However, the maximum employer-paid premium that any highly-compensated employee may receive tax free is limited by the employer premium provided in the coverage made available to 90 percent of the rank-and-file employees. Specifically, a highly-paid employee

(MORE)

may not exclude from taxable income any employer-paid premium that exceeds 133 percent of the employer premium in the coverage made available to 90 percent of the rank and file. In addition, the bill responds to many other concerns raised about present-law Section 89, such as the treatment of part-time employees, leased employees, and union employees.

"I am confident that this simplification bill is responsive to the complaints leveled against Section 89 about its complexity and the burdensomeness of its data-gathering requirements. Under the approach taken in this bill, an employer does not have to perform the data collection required under present law, with respect to which low-paid employees receive coverage, which employees have families, and which are covered by the plan of a spouse or parent.

"This approach, however, does not signal a retreat from the objectives of Section 89 in promoting broad-based health coverage, and limiting the tax advantages of health plans that excessively benefit highly-paid employees.

"A revenue estimate of the bill I am introducing has not yet been prepared. However, the revenue consequences of this bill will, of course, have to be considered as the bill moves through the legislative process."

DESCRIPTION OF H.R. 1864, SECTION 89 SIMPLIFICATION

H.R. 1864 would replace the current section 89 nondiscrimination rules with a single simplified test. An employer's health program would pass the proposed test if there is no provision that is discriminatory on its face, and:

-- core health coverage is available to at least 90 percent of the employer's rank-and-file employees, with an employee premium of no more than $10 per week (indexed) in the case of individual coverage, or $25 per week (indexed) in the case of family coverage, and

-- the maximum amount of employer-paid premium that may be excluded from the income of any highly-compensated employee is no more than 133 percent of the employer-paid premium in the plan made available to 90 percent of the rank-and-file employees.

Additional Relief:

o Part-time employees. -- Employees who work less than 25 hours per week would not have to be considered (rather than 17.5 hours, as under present law).

o Leased employees. -- Generally, leased employees would not have to be considered if the leasing company makes available to the leased employees core health coverage meeting the maximum-premium requirements. This rule would apply in the same way as similar rules relating to pension plans.

o Union plans. -- Union plans would be tested separately. This rule will make it easier for many union plans, including plans maintained by State and local governments, to pass the tests. This is similar to the rules for pension plans.

o Former employees. -- The rules would be delayed one year. In applying the rules to former employees, employees who separate from service before January 1, 1990, would be disregarded.

o Penalty for failure of a plan to be in writing. -- An excise tax would be imposed on the employer if a plan fails to meet the writing, notice or other qualification rules of Section 89 (under present law, reimbursements under the plan are taxable to the employees who received them). This provides greater fairness to employees.

(MORE)

Effective date:

The proposal would be effective for 1990. However, the employer would be permitted to use either present law, or the new rules, for 1989. This will allow employers flexibility in the design of their program, and is fair to those employers who have already attempted to comply with present law.

Advantages of the Proposal:

- Reduced data collection. -- The proposal eliminates the need to collect much of the data required for Section 89 under present law. For example, the employer has no need to determine the family status of an employee or whether an employer has coverage elsewhere.
- Passage on the basis of plan design. -- Employers will be able to structure their health program to pass the proposed test on the basis of plan design.
- One-day-a-year testing. -- Whether an employer meets the test may generally be determined on the basis of the facts relating to one day in the year.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard by telephone to Harriett Lawler or Diane Kirkland [(202) 225-1721] no later than Monday, April 24, 1989, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee [(202) 225-1721)].

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearings. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are requested to briefly summarize their written statements. The full statement will be included in the printed record.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Committee are required to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Friday, May 12, 1989, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, before the hearing begins.

(MORE)

SEE FORMATTING REQUIREMENTS BELOW:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

I

101ST CONGRESS
1ST SESSION

H. R. 1864

To amend the Internal Revenue Code of 1986 to simplify the antidiscrimination rules applicable to certain employee benefit plans.

IN THE HOUSE OF REPRESENTATIVES

APRIL 13, 1989

Mr. ROSTENKOWSKI (for himself, Mr. FOLEY, Mr. GIBBONS, Mr. PICKLE, Mr. RANGEL, Mr. STARK, Mr. JACOBS, Mr. FORD of Tennessee, Mr. JENKINS, Mr. GEPHARDT, Mr. DOWNEY, Mr. GUARINI, Mr. RUSSO, Mr. PEASE, Mr. MATSUI, Mr. ANTHONY, Mr. FLIPPO, Mr. DORGAN of North Dakota, Mrs. KENNELLY, Mr. DONNELLY, Mr. COYNE, Mr. ANDREWS, Mr. LEVIN of Michigan, Mr. MOODY, Mr. VANDER JAGT, Mr. SCHULZE, Mr. GRADISON, Mr. THOMAS of California, Mr. McGRATH, Mr. CHANDLER, and Mr. WOLPE) introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1986 to simplify the antidiscrimination rules applicable to certain employee benefit plans.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. REVISION OF ANTIDISCRIMINATION RULES FOR CERTAIN EMPLOYEE BENEFIT PLANS.

(a) GENERAL RULE.—Section 89 of the Internal Revenue Code of 1986 (relating to benefits provided under certain employee benefit plans) is amended to read as follows:

"SEC. 89. HEALTH BENEFITS PROVIDED TO HIGHLY COMPENSATED EMPLOYEES.

"(a) INCLUSION IN INCOME.—

"(1) IN GENERAL.—Notwithstanding section 106, gross income of a highly compensated employee who is a participant in a health plan during any testing year shall include an amount equal to such employee's taxable benefit under such plan for such testing year.

"(2) YEAR OF INCLUSION.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), any amount included in gross income under paragraph (1) shall be taken into account for the taxable year of the employee with or within which the testing year ends.

"(B) ELECTION TO DELAY INCLUSION FOR 1 YEAR.—If an employer maintains a plan with a testing year ending after September 30 and on or before December 31 of a calendar year and elects the application of this subparagraph—

"(i) amounts included in gross income under paragraph (1) with respect to employees of such employer shall be taken into account for the taxable year of the employee following the taxable year determined under subparagraph (A), but

"(ii) any deduction of the employer which is attributable to such amounts shall be allowable for the taxable year with or within which the testing year following the testing year in which the taxable benefits were provided ends.

"(b) TAXABLE BENEFIT.—For purposes of this section—

"(1) TAXABLE BENEFIT UNDER PLANS NOT MEETING ELIGIBILITY REQUIREMENTS.—The taxable benefit of any highly compensated employee under any health plan not meeting the requirements of subsection (c) is the amount of such employee's employer-provided benefit under such plan.

"(2) TAXABLE BENEFIT UNDER PLANS MEETING ELIGIBILITY REQUIREMENTS.—

"(A) IN GENERAL.—The taxable benefit of any highly compensated employee under health plans meeting the requirements of subsection (c) is the excess (if any) of—

"(i) such employee's aggregate employer-provided benefit under such plans, over

"(ii) 133 percent of the amount which would have been such employee's employer-provided benefit if he had been a participant with the same status in the plan which was taken into account in determining whether the requirements of subsection (c)(1)(B) are met and which would result in the smallest employer-provided benefit determined for purposes of this clause.

An employer may elect for any testing year to treat the amount determined under clause (ii) as being zero.

"(B) SPECIAL RULE FOR FAMILY COVERAGE.—For purposes of subparagraph (A)(ii), family coverage shall be disregarded unless at least 90 percent of all employees who are not highly compensated employees are eligible to participate in qualified core health plans providing family coverage.

"(C) AGGREGATION OF PLANS.—For purposes of subparagraph (A)(ii), an employer may elect to treat any group of 2 or more health plans as 1 plan if—

"(i) each of such plans is available to the same group of employees with the same eligibility requirements, and

"(ii) such plans when so aggregated qualify as a qualified core health plan.

"(c) REQUIREMENTS.—

"(1) IN GENERAL.—For purposes of this section, a health plan meets the requirements of this subsection if—

"(A) such plan does not contain any provision relating to eligibility to participate which (by its terms or otherwise) discriminates in favor of highly compensated employees, and

"(B) the employer maintains 1 or more qualified core health plans and at least 90 percent of all employees who are not highly compensated employees are eligible to participate in any of such plans.

"(2) QUALIFIED CORE HEALTH PLAN.—For purposes of this section, the term 'qualified core health plan' means any health plan if—

"(A) the employer-provided benefit under such plan primarily consists of core benefits, and

"(B) such health plan does not require contributions by the employee in excess of $10.00

per week ($25.00 per week in the case of family coverage).

"(3) COST-OF-LIVING ADJUSTMENT.—In the case of testing years beginning after 1989, each dollar amount set forth in paragraph (2) shall be increased by the percentage (if any) by which—

"(A) the SSA average wage index (as defined in section 215(i)(1)(G) of the Social Security Act) for the calendar year preceding the calendar year in which the testing year begins, exceeds

"(B) such index for 1988.

"(d) EXCLUDED EMPLOYEES.—

"(1) IN GENERAL.—The following employees shall be excluded from consideration under this section:

"(A) Employees who have not completed 6 months of service. An employee shall be excluded from consideration until the 1st day of the 1st month (or 1st day of a period of less than 31 days specified by the plan) beginning after completion of the period of service required under the preceding sentence.

"(B) Employees who normally work less than 25 hours per week.

"(C) Employees who normally work during not more than 6 months during any year.

"(D) Employees who have not attained age 21.

"(E) Employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from the employer which constitutes income from sources within the United States (within the meaning of section 861(a)(3)).

"(F) Employees who are students if—

"(i) such students are performing services described in section 3121(b)(10), and

"(ii) core health coverage is made available to such students by such employer.

Subparagraphs (A), (B), (C), and (D) shall be applied by substituting a shorter period of service, smaller number of hours or months, or lower age specified in the plan for the period of service, number of hours or months, or age (as the case may be) specified in such subparagraph.

"(2) CERTAIN EXCLUSIONS NOT TO APPLY IF EXCLUDED EMPLOYEES COVERED.—Except to the extent provided in regulations, employees shall not be excluded from consideration under any subparagraph of paragraph (1) (other than subparagraph (E)) unless no employee described in such subparagraph (determined with regard to the last sentence of paragraph (1)) is eligible under the plan.

"(3) EXCLUSION MUST APPLY TO ALL PLANS.—An exclusion shall apply under any subparagraph of paragraph (1) (other than subparagraph (E) thereof) only if the exclusion applies to all health plans of the employer.

"(4) EXCEPTION FOR SEPARATE LINE OF BUSINESS.—If any line of business is treated separately under subsection (e)(4), then paragraphs (2) and (3) shall be applied separately to such line of business.

"(e) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) HEALTH PLAN.—The term 'health plan' means an accident or health plan within the meaning of section 105(e). Such term shall not include a plan maintained by a church for church employees. For purposes of the preceding sentence, the term 'church' means any church (as defined in section 3121(w)(3)(A)) or qualified church-controlled organization (as defined in section 3121(w)(3)(B)).

"(2) HIGHLY COMPENSATED EMPLOYEE.—The term 'highly compensated employee' has the meaning given such term by section 414(q); except that paragraph (5)(B) of such section shall not apply.

"(3) Employer-provided benefit.—

"(A) In general.—An employee's employer-provided benefit under any health plan is the value of the coverage provided during the testing year to or on behalf of such employee to the extent attributable to contributions made by the employer.

"(B) Determination of value.—The value of the coverage provided by any health plan shall be determined under procedures prescribed by the Secretary which shall—

"(i) set forth the values of various standard types of coverage involving a representative group, and

"(ii) provide for adjustments to take into account the specific coverage and group involved.

"(C) Salary reduction.—Any contribution by reason of a salary reduction arrangement—

"(i) shall be treated as an employer contribution for purposes of determining a highly compensated employee's employer-provided benefit, but "(ii) shall be treated as an employee contribution for purposes of subsections (b)(2)(A)(ii) and (c).

"(D) SPECIAL RULE FOR MULTIEMPLOYER PLANS.—

'(i) IN GENERAL.—Except as provided in regulations and clause (ii), an employer may treat the contribution such employer makes to a multiemployer plan on behalf of an employee as the employer-provided benefit of such employee under such plan.

"(ii) ADJUSTMENT.—If—

"(I) the allocation of plan benefits between highly compensated employees and other employees under a multiemployer plan (or within either of such groups) varies materially from the allocation of employer contributions to such plan, or

"(II) the employer contributions relate to benefits of different types,

the employer-provided benefit determined under clause (i) shall be appropriately adjusted to take into account such material variation or such employer contribution.

"(iii) EXCEPTION FOR PROFESSIONALS.—This subparagraph shall not apply to any employer maintaining a multiemployer plan if such employer makes contributions to such plan on behalf of any individual performing services in the field of health, law, engineering, architecture, accounting, actuarial science, financial services, or consulting or in such other fields as the Secretary may prescribe.

"(4) SEPARATE LINE OF BUSINESS EXCEPTION.—If, under section 414(r), an employer is treated as operating separate lines of business for a year, the employer may apply the preceding provisions of this section separately with respect to employees in each such separate line of business. The preceding sentence shall not apply to any plan unless such plan is available to a group of employees as qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of highly compensated employees. In applying section 414(r)(7) for purposes of this section, an operating unit shall be treated as in a separate geographic area from another unit if such units are all at least 35 miles apart.

"(5) SPECIAL RULE FOR EMPLOYEES WORKING LESS THAN 30 HOURS PER WEEK.—In the case of employees who normally work less than 30 hours per week—

"(A) the employer-provided benefit, and

"(B) the limitation of subsection (c)(2)(B),

shall be proportionately increased.

"(6) TESTING YEAR.—The term 'testing year' means—

"(A) any 12-month period beginning with the calendar month designated in the plan for purposes of this section, or

"(B) if there is no such designation, the calendar year.

No period may be designated under subparagraph (A) unless the same period is designated with respect to all other health plans of the employer. Any designation under subparagraph (A) may be changed only with the consent of the Secretary.

"(7) TIME FOR TESTING.—

"(A) IN GENERAL.—Except as provided in regulations prescribed by the Secretary, determinations under this section (other than the determination of a highly compensated employee's actual employer-provided benefit) shall be made on the basis of the facts as of the testing day.

"(B) TESTING DAY.—For purposes of this paragraph, the term 'testing day' means—

"(i) the day designated in the plan as the testing day for purposes of this paragraph, or

"(ii) if there is no day so designated, the last day of the testing year.

"(C) LIMITATIONS.—

"(i) DESIGNATION MUST BE CONSISTENT FOR ALL HEALTH PLANS.—No day may be designated under subparagraph (B)(i) with respect to any plan unless the same day is so designated with respect to all other health plans of the employer.

"(ii) DESIGNATION BINDING.—Any designation under subparagraph (B)(i) shall apply to the testing year for which made and all subsequent years unless revoked with the consent of the Secretary.

"(D) SPECIAL RULE FOR MULTIPLE EMPLOYER PLAN.—In the case of a multiemployer plan or any other plan maintained by more than 1 employer, each employer may, subject to such rules as the Secretary may prescribe, elect its own testing year under paragraph (6) and its own testing date under this paragraph.

"(8) TREATMENT OF UNION EMPLOYEES.—

"(A) IN GENERAL.—If an employer has employees included in any qualified bargaining unit, this section shall be applied separately with respect to employees included in each such unit.

"(B) QUALIFIED BARGAINING UNIT.—For purposes of subparagraph (A), the term 'qualified bargaining unit' means any unit of employees covered by an agreement which the Secretary finds to be a collective bargaining agreement between employee representatives and 1 or more employers if—

"(i) there is evidence that health benefits were the subject of good faith bargaining between the employee representatives and such employer or employers, and

"(ii) not more than a de minimis number of employees in such unit perform services in the field of health, law, engineering, architecture, accounting, actuarial science, financial services, or consulting or in such other fields as the Secretary may prescribe.

"(9) **Treatment of former employees.**—Except to the extent provided in regulations, this section shall be applied separately to former employees under requirements similar to the requirements that apply to employees.

"(10) **Special rules for certain dispositions or acquisitions.**—

"(A) **In general.**—If a person becomes, or ceases to be, a member of a group described in subsection (b), (c), (m), or (o) of section 414, then the requirements of subsection (c) shall be treated as having been met during the transition period with respect to any plan covering employees of such person or any other member of such group if—

"(i) such requirements were met immediately before such change, and

"(ii) either—

"(I) the coverage under such plan is not significantly changed during the transition period (other than by reason of the change in members of such group), or

"(II) such plan meets such other requirements as the Secretary may prescribe by regulation.

"(B) TRANSITION PERIOD.—For purposes of subparagraph (A), the term 'transition period' means the period—

"(i) beginning on the date of the change in members of a group, and

"(ii) ending on the last day of the 1st plan year beginning after such date of change.

"(11) COORDINATION WITH MEDICARE, ETC.—

"(A) IN GENERAL.—If a plan is coordinated with health or disability benefits provided under any Federal, State, or foreign law or under any other health plan covering the employee or family member of the employee, such plan shall not fail to meet the requirements of subsection (c) merely because the amount of benefits provided to an employee or family member are coordinated in a manner which does not discriminate in favor of highly compensated employees.

"(B) CERTAIN DISABILITY PLANS EXEMPT FROM NONDISCRIMINATION RULES.—This section shall not apply to any disability coverage other than disability coverage the benefits of which are excludable from gross income under section 105(b) or (c).

"(12) EMPLOYERS WITH ONLY HIGHLY COMPENSATED EMPLOYEES.—This section shall not apply to any health plan for any year if the only employees of the employer maintaining such plan are highly compensated employees.

"(13) SAFE HARBOR FOR CERTAIN LEASED EMPLOYEES.—

"(A) IN GENERAL.—Subsection (n) of section 414 (relating to employee leasing) shall not apply for purposes of this section to any leased employee with respect to services performed for a recipient if—

"(i) the leasing organization certifies that such employee is eligible to participate in a qualified core health plan which is maintained by the leasing organization (and the recipient has no reason to believe that such certification is not correct), and

"(ii) leased employees (determined without regard to this paragraph) do not constitute more than 20 percent of the recipient's nonhighly compensated workforce.

"(B) DEFINITIONS.—For purposes of this paragraph, the terms 'leased employee', 'leasing organization', and 'nonhighly compensated work force' have the same respective meanings as when used in section 414(n).

"(f) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

(b) EXCISE TAX ON PLANS NOT MEETING CERTAIN REQUIREMENTS.—

(1) IN GENERAL.—Chapter 43 of such Code is amended by adding at the end thereof the following new section:

"SEC. 4980C. FAILURE TO SATISFY CERTAIN REQUIREMENTS WITH RESPECT TO EMPLOYEE BENEFITS PLANS.

"(a) GENERAL RULE.—In the case of an employer, there is hereby imposed a tax equal to 34 percent of the amounts paid or incurred during any taxable year under a specified employee benefit plan which does not meet the requirements of subsection (b).

"(b) REQUIREMENTS.—A specified employee benefit plan does not meet the requirements of this subsection unless, except to the extent provided in regulations—

"(1) such plan is in writing,

"(2) the employee's rights under such plan are legally enforceable,

"(3) employees are provided reasonable notification of benefits available in the plan,

"(4) such plan is maintained for the exclusive benefit of employees, and

"(5) such plan was established with the intention of being maintained for an indefinite period of time.

"(c) SPECIFIED EMPLOYEE BENEFIT PLAN.—For purposes of this section, the term 'specified employee benefit plan' means—

"(1) an accident or health plan (within the meaning of section 105(e)),

"(2) any plan of an employer for providing group-term life insurance (within the meaning of section 79),

"(3) a qualified tuition reduction program (within the meaning of section 117(d)),

"(4) a cafeteria plan (within the meaning of section 125),

"(5) a fringe benefit program providing no-addition-cost services, qualified employee discounts, or employer-operated eating facilities which are excludable from gross income under section 132, and

"(6) a plan to which section 505 applies.

"(d) **Regulations.**—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

(2) **Clerical amendment.**—The table of sections for chapter 43 of such Code is amended by adding at the end thereof the following new item:

"Sec. 4980C. Failure to satisfy certain requirements with respect to employee benefits plans."

(c) **Nondiscrimination Requirements for Group-Term Life Insurance.**—

(1) **Restoration of prior law.**—The amendment made by section 1151(c)(1) of the Tax Reform Act of 1986 is hereby repealed and section 79(d) of the Internal Revenue Code of 1986 shall be applied and administered as if the amendment made by such section 1151(c)(1) had not been enacted.

(2) **Exclusion of certain employees.**—Subparagraph (B) of section 79(d)(3) of such Code (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) is amended to read as follows:

"(B) **Exclusion of certain employees.**—For purposes of subparagraph (A), there may be excluded from consideration employees who may be excluded from consideration under rules similar to the rules of section 89(d) (determined by substituting '1 year' for '6 months' in paragraph (1)(A) thereof)."

(d) 1-YEAR DELAY IN APPLICATION TO RETIRED EMPLOYEES.—Paragraph (2) of section 3021(c) of the Technical and Miscellaneous Revenue Act of 1988 is amended—

(1) by striking "January 1, 1989" and inserting "January 1, 1990", and

(2) by striking "December 31, 1988" each place it appears and inserting "December 31, 1989".

(e) CONFORMING AMENDMENTS.—

(1) Sections 117(d)(4), 125(b)(3), 127(b)(2), 129(d)(8), and 505(b)(2) of such Code are each amended by striking "section 89(h)" and inserting "rules similar to the rules of section 89(d) (determined by substituting '1 year' for '6 months' in paragraph (1)(A) thereof)".

(2) Sections 120(b)(2), 125(c)(1), 127(b)(1)(B), and 129(d)(1)(B) of such Code are each amended by striking "89(k)" and inserting "4980C".

(3) Subparagraph (C) of section 125(c)(2) of such Code is amended by striking the last sentence thereof.

(4) Paragraph (1) of section 125(e) of such Code is amended by striking "section 89(a)" and inserting "sections 79(d) and 89(a)".

(5) Subparagraph (B) of section 162(l)(2) of such Code is amended by inserting "and treating individuals who are employees within the meaning of section 401(c)(1) as employees" before the period at the end thereof.

(6)(A) Subsection (b) of section 4976 of such Code is amended by striking paragraph (5).

(B) Subparagraph (B) of section 4976(c)(1) of such Code is amended to read as follows:

"(B) a health or group-term life insurance plan is part of such fund and benefits under such plan are taxable under chapter 1 by reason of section 79(d) or 89,".

(C) Clause (i) of section 4976(c)(2)(A) of such Code is amended to read as follows:

"(i) the aggregate benefits referred to in paragraph (1)(B), or".

(D) Clause (ii) of section 4976(c)(2)(A) of such Code is amended by striking "such testing year" and inserting "the plan year".

(7) Section 6051 of such Code is amended by adding at the end thereof the following new subsection:

"(g) REPORTING REQUIREMENTS FOR CERTAIN TAXABLE FRINGE BENEFITS.—

"(1) In general.—If an employee of an employer maintaining any plan is required to include any amount in gross income under section 79(d) or 89 for any year ending with or within a calendar year, the employer shall separately include such amount on the statement which the employer is required to provide the employee under subsection (a) (and any statement required to be furnished under subsection (d)).

"(2) Penalty.—

"For penalty for failure to report, see section 6652(k)."

(8)(A) Paragraph (1) of section 6652(k) of such Code is amended by striking "89(l)" and inserting "6051(g)".

(B) Paragraph (2) of section 6652(k) of such Code is amended by striking subparagraph (B) and inserting the following:

"(B) an amount which bears the same ratio to the employer-provided benefit with respect to the individual to whom such failure relates as the amount required to be but not shown on timely statements under sections 6051(a) and 6051(d) bears to the amount required to be shown.

For purposes of subparagraph (B), the term 'employer-provided benefit' means the employer-provided benefit determined under section 89 in the case of a health benefit and the cost of insurance determined under section 79(c) in case of a plan providing group-term life insurance."

(9) The table of sections for part II of subchapter B of chapter 1 of such Code is amended by striking the item relating to section 89 and inserting the following:

"Sec. 89. Health benefits provided to highly compensated employees."

(10) Section 6070 of the Technical and Miscellaneous Revenue Act of 1988 is hereby repealed.

(f) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to years beginning after December 31, 1989; except that the amendments made by subsection (d) shall apply to years beginning after December 31, 1988.

(2) ELECTION TO HAVE AMENDMENTS APPLY IN 1989.—An employer may elect to have the amendments made by this section apply to years beginning after December 31, 1988. Such election shall apply to all plans of the employer and, once made, shall be irrevocable.

(3) RETENTION OF TRANSITIONAL RULES.—The rules of section 1151(k)(2) of the Tax Reform Act of 1986 and subsection (c) of section 3021 of the Technical and Miscellaneous Revenue Act of 1988 (as amended by subsection (d)) shall continue to apply for pur-

poses of the amendments made by this section, except that—

(A) the reference to section 89(g)(3)(B) in section 3021(c)(1)(A) of the Technical and Miscellaneous Revenue Act of 1988 shall be treated as a reference to section 89(e)(3)(B),

(B) the reference to subsections (d), (e), and (f) of section 89 in section 3021(c)(1)(B)(ii) of such Act shall be treated as a reference to section 89(c), and

(C) the reference to section 89(k)(1)(A) in section 3021(c)(3) of such Act shall be treated as a reference to section 4980C(b)(1).

(4) REGULATIONS.—The Secretary of the Treasury or his delegate shall prescribe regulations to carry out the amendments made by this section not later than the date 6 months after the date of the enactment of this Act.

Mr. **Pickle** [presiding]. We will ask the committee to please come to order, and we will ask our guests to please find a seat so that we may proceed.

Good morning.

On April 13, Chairman Rostenkowski, along with 28 members of this committee, and the majority leader, Tom Foley, introduced H.R. 1864, a bill to reform and simplify section 89 of the Internal Revenue Code.

Over the next 2 days, the committee will take testimony on this bill. I am proceeding in the chairman's place now, because he has been delayed, but will be here in a few minutes to resume the chair.

H.R. 1864 significantly simplifies the present law, section 89. It does not retreat from its fundamental objective of ensuring that tax-favored health benefits are provided in a fair and broad-based manner. Like present law, this bill would ensure that a Federal tax subsidy is not available for employer-provided health insurance unless the employer offers affordable health care to rank-and-file employees.

But instead of the complex test of the present law, H.R. 1864 provides a single, simplified, design-based test. Consequently, no data gathering is necessary to pass the test.

Chairman Rostenkowski and many other members believe this bill is a very good bill. It responds to the employer complaints about the complexity of present law. It responds to reasonable objections concerning testing for part-time employees, leased employees, and union employees.

But this bill does not accommodate those who believe we should simply abandon the goal of providing tough, nondiscrimination rules for health plans. This bill makes it easier to test whether the employer's health insurance program is fair, but does not make it easier to provide significantly better tax-favored health benefits to high-paid employees than to rank-and-file employees.

Accordingly, Chairman Rostenkowski did not introduce this bill as the first bargaining chip in a negotiating process. He has asked me to indicate that he is not interested in adding more safe harbors, alternative tests, aggregation rules, and so forth, to make it easier for specific employees to pass.

We have been down that road before, and we have seen that this approach only adds complexity and unfairness to the rules. Nor is he interested in loosening the bill so that it has no real effect.

However, the chairman and other members are very interested in learning whether there are major problems or hidden complexities in the bill that make it unworkable for the average employer.

With this in mind, we are hopeful that all of our witnesses here today can help us devise a rule that meets the twin objectives of fairness and simplicity. That is Chairman Rostenkowski's statement, and I repeat that he is en route to the committee and should be here in a few minutes.

Before we recognize our first witness, I would yield to Mr. Archer for any opening statement that he might make.

Mr. **Archer**. Mr. Chairman, thank you.

Today's hearing marks the second time in less than a year that the committee has considered legislation to simplify section 89 and make it more workable.

I must say at the outset that I opposed section 89 in 1986 and voted against it, so my position is very clear on this issue. I think it would be much simpler to repeal section 89.

However, H.R. 1864 is clearly an improvement over the current law in that it removes a good bit of the complexity in this area. Given the strong interest in Congress in resolving this issue, I commend Chairman Rostenkowski for calling these hearings, which will allow us to explore the impact of H.R. 1864 as an alternative to current law. I look forward to hearing from today's witnesses regarding their views on whether modifications of this proposal might be necessary and appropriate in resolving this issue once and for all.

In the intervening weeks since the bill was introduced, a number of significant concerns have been raised about provisions in H.R. 1864, such as the 90-percent coverage requirement, the $10, and $25 premium amounts, the impact on cafeteria plans, and other specific items.

I am sure that the witnesses will point out other concerns as well, which have arisen during their analysis of the proposal before us. That's what hearings are all about.

And I know that the members of the Ways and Means Committee join me in welcoming that input. The committee has demonstrated on many occasions that it has the ability to keep an open mind in reconciling significant differences as it meets the challenge of shaping a final legislative product to meet an identified need.

In this regard, I want to note that Secretary of the Treasury, Nicholas Brady, yesterday stated Treasury's willingness to work with the committee to make compliance with section 89 easier. I compliment the Secretary for his decision to delay compliance with section 89 until October 1, of this year. That is a significant step in providing the Nation's employers time to adjust to changes we might make in the law.

Given the extensive number of witnesses scheduled to appear before the committee, I will end my opening remarks here. I look forward to hearing from the distinguished array of witnesses and look forward to working with Chairman Rostenkowski in improving section 89.

Mr. PICKLE. Thank you, Mr. Archer.

Now, the Chair has been advised that other members want to make opening statements, and, accordingly, the Chair would recognize them.

Let me remind the members, though, that we have a long number of witnesses which we want to hear.

The Chair will recognize Mr. Rangel for an opening statement.

Mr. RANGEL. Thank you, Mr. Chairman.

I just want to reaffirm my position in making certain that health benefits provided to employees remain exempt from taxation and to point out that when the majority of this committee was successful in protecting those fringe benefits provisions in tax reform, I had initiated what is now referred to as section 89 to make certain as it relates to employees that we had fairness and equity regardless of the salary schedule of that particular employee.

It is necessary that we don't have abuse of the law in this area and obviously the provisions of section 89 cause more confusion and translation than it did in benefits and that's why I want to join with the chairman in attempting to correct the situation.

And I do hope that those that are in support of continuing the exemption from taxation of fringe benefits would work with this committee in the spirit in which section 89 was enacted by the Congress, and that is to make certain that we don't find certain employers discriminating against lower-paid employees.

I want to thank you, Mr. Chairman.

Mr. PICKLE. Thank you, Mr. Rangel.

Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman.

Mr. Chairman, I appreciate the willingness of our Chairman Rostenkowski to take another look at changes which we made in 1986, and again last year in section 89.

The testimony received in advance of today's hearings contains several recurring themes which do not alter the substance or objectives of our committee's efforts to eliminate discriminatory practices in the provision of employee benefits.

I am thinking specifically of problems created by our work in refining section 89, and the inability of employers to promptly respond. We are now working on the third significant change in section 89 in 4 years. We must include in our present efforts specific definitions of key concepts to give employers as much guidance as possible before the next set of IRS regulations is promulgated.

We should also include protection for those who have made good faith efforts to comply with the new law. The complexity of these issues virtually assures that honest mistakes will occur in the next year or two. Imposing severe penalties soon after the changes are effected could discourage employers from extending or expanding employee benefits.

Mr. Chairman, I continue to support the premise that statutory employee benefit plans should be broadly based and should not favor highly compensated employees, and I hope we can obtain those goals with as little consternation as possible.

Thank you, Mr. Chairman.

Ms. KENNELLY. Mr. Chairman, may I have permission to put my statement on the record?

Mr. PICKLE. Yes.

Ms. KENNELLY. Thank you, Mr. Chairman.

I just wish to join with the others in applauding Chairman Rostenkowski's decision to hold these hearings to garner additional input, and to say that I do not believe in taxing health benefits, but at the same time believe in the concept of nondiscriminatory health benefits.

[Mrs. Kennelly's opening statement follows:]

OPENING STATEMENT OF HON. BARBARA B. KENNELLY

Thank you, Mr. Chairman. I applaud you for introducing this bill to simplify Section 89 and for holding these hearings to garner additional input. First let me say that I don't believe in taxing employee benefits and I do believe in the concept behind Section 89—assuring that health benefits are offered on a nondiscriminatory basis.

We have all been hearing various complaints, some real and some imagined, about Section 89 for several months now. In my mind, this set of hearings and the Chairman's new proposal, H.R. 1864, respond to the real concerns expressed by some employers.

Specifically, relief for leased employees, prospective coverage of former employees, a new definition of part-time workers, the incentive to offer family coverage to rank-and-file employees, and the introduction of a design-based test are major improvements over current law.

I remain concerned, however, about the adequacy of the maximum employee premium. I just don't know if it is realistic in terms of the actual cost of coverage. I hope we can ascertain this information today and tomorrow.

It is also imperative, however, that coverage, and family coverage in particular, remain affordable to low paid employees. In the event that the current premiums are not sufficient, I think perhaps we need to search for an alternative device—perhaps a percentage of compensation.

Finally, I think an optional incentive is needed, and let me underscore the words optional, and incentive, to induce employers to offer coverage to those who work less than 25 hours a week. I would welcome the comments of any of the witnesses in this area.

Thank you.

Mr. **Pickle**. Thank you, Ms. Kennelly.

Now, Mr. Chandler.

Mr. **Chandler**. Mr. Chairman, I don't want to take very much of the committee's time, but I do want to commend Chairman Rostenkowski for his introduction of H.R. 1864 of which I am a cosponsor. I believe H.R. 1864 represents a very substantial improvement over current section 89.

The primary focus of the national debate on health care coverage concerns finding ways to expand coverage. While an estimated 136 million people are covered under private employer-provided health insurance, there are still 35 million people who have no coverage.

Now, we are trying to find ways to extend coverage to those people. Clearly, it would be counterproductive to first, impose new taxes on health care coverage, or second, try to institute fairness through a method that is incredibly complex.

In order to encourage expansion of medical coverage, we have to take great care that we do not complicate the matter so much that we go back to the days where we have just been—where employers actually throw up their hands and discontinue coverage.

I want to commend the chairman for his decision not to include a health care tax cap in this bill, as my colleague from Connecticut has just pointed out.

Thank you very much, Mr. Chairman.

Mr. **Pickle**. Now, our first witness this morning will be Mr. Dana Trier, representing the Department of the Treasury.

Mr. Trier, if you will come to the witness table.

Mr. Trier is the Tax Legislative Counsel, Office of the Assistant Secretary for Tax Policy.

And, Mr. Trier, we will ask you to proceed.

Your entire statement will be included in the record.

STATEMENT OF DANA L. TRIER, TAX LEGISLATIVE COUNSEL, OFFICE OF THE ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. **Trier**. Thank you, Mr. Chairman.

I would like to make a few introductory remarks and then get into the details a little bit on H.R. 1864.

First, as an introductory remark, as has been said several times, Secretary Brady and the whole administration are very much in favor of a complete revision of section 89. We are very convinced that it is simply not workable in its current form.

In that light we applaud Chairman Rostenkowski and the others who sponsored H.R. 1864. We think that it is a major step forward in making section 89 and the governance of health benefits much more workable. We are, however, continuing to look at various aspects of it. We want to be absolutely certain we have got it right this time, and we've got something that is comprehensible and administrable; but we do really think that it is a major step forward with some of the caveats that I'll address later in my testimony.

As was announced by Secretary Brady yesterday to accommodate the legislative process, which we hope is a very prompt process in dealing with revising section 89, the Secretary has made the decision that the optional testing year for the 1989 year, for the first year of the effective date of section 89 will be moved—its beginning date will be moved at the option of the employer from July 1 to October 1.

The way this works, Mr. Chairman, is that before we had a July 1 date to accommodate the fact that the regs were issued part of the way through the 1989 year. Under that July date, the employer could elect to have a short testing year for the first year and then annualize the benefits provided under that to determine whether it was a discriminatory plan for the whole first year of 1989.

Obviously that July 1 date was selected at a time early in the year when we thought the major problem was that there was insufficient guidance put forth after TAMRA. We now find ourselves in a situation where virtually everyone is in favor of substantial revision of section 89. As that process goes forward, we think it appropriate to move the July 1 date to October 1.

And we are looking at all other aspects of the regulations to accommodate this process, while at the same time, enforcing the law as it is on the books.

Now, a few comments about the bill. As I said before, we think it is a major step forward. The key way that the bill is a step forward is it moves towards a more design-based system, the magic words that all of us in Washington are now mouthing, when we are talking about section 89. The key there is that with limited exceptions, complicated valuation and the application of multiple tests is not going to be required.

We want to be very careful, as I said at the outset, that we have gotten it right this time. As everybody has pointed out, this is the third time at the well, and as a result we are continuing to analyze every aspect of the test very carefully and we are doing that with the thought at the outset that the last thing we want to do is to come up with 35 exceptions and 40 exceptions to the 35 exceptions and come out with as complicated a mess as we have now.

As I said, our analysis is still going forward, but I would like to address a few things, which we really are concentrating on in our own analysis, and want to make sure work before we are willing to give the bill as it stands a blessing.

I think the major overall thing that we are doing is addressing how the core nondiscrimination tests work in everyday practical situations. We like you, I'm sure, are talking to employer groups, a wide variety of employer groups, to address this question; and we want to be very certain that the way all the parts of the tests relate to each other comes out with an overall package that really will accommodate things consistent with simplicity and fairness to the employees involved.

The core nondiscrimination test, as you know, the basic eligibility requirement, that is at the foundation of it, that there be offered a primarily core health benefits to at least 90 percent of the employees at a cost that does not exceed for individuals $10 per week, or for families $25 a week. And that cost is to be indexed according to a wage-based index factor.

As I said, we are carefully looking at these tests in their actual operation. It is absolutely clear to us that we have made major progress with this test. One of the aspects of it that we are continuing to concentrate on at this point is whether the wage-based inflation factor is the correct one, and we fully understand why Chairman Rostenkowski and the other sponsors adopted it. The theory for it being wage based as opposed to health cost based is, of course, that this whole test is premised on the availability to the employees so that their financial situation is key to the whole thing.

We want to make certain as it operates in the event that health costs did rise, but the wages didn't rise quite as much, that we don't end up with the operation of this test occurring in a way that we have actually defeated some of our goals.

The second thing that we are looking at, which I think several of the Congressmen in their opening statements alluded to is exactly how these tests operate in the setting of so-called salary-reduction arrangements or cafeteria arrangements under which the employee gets a choice of whether he takes his money or participates in one of these plans, including a health plan.

Again, we understand fully why the position in the bill was adopted, basically for purposes of the core 133⅓-percent test. There is a difference in treatment between how salary-reduction contributions are viewed for the highly compensated and the nonhighly compensated.

For the highly compensated, they are viewed as tantamount to employer contributions and tantamount to employee contributions for the nonhighly compensated.

Although we understand why that approach was taken, we view it as an open question at this point, whether this is the most workable way to dealing with salary reduction plan arrangements, and we are continuing to study that, and hopefully literally within a few days we can address that in a definitive way.

The third aspect of the nondiscrimination rules that we have concentrated on—and I think this has been a pervasive question as we have all tried to deal with section 89—is the question whether or not there should be some special treatment—I don't mean an outright exception—but some special treatment for small businesses. And we do have a sense in our own mind that in fact such a special treatment may be warranted, and the basic reason for that is when you get down to a small, at least 10 or under, group of employees, that the insurance costs, the insurance arrangements, in fact, really differ from what they do for a large employer.

You have much more individually rated plans. The cost itself may go up so that the $10 number, and the $25 number don't work out in practice as well, and for that reason we think it is very important at this juncture to analyze carefully whether we could have an exception.

We are suggesting in our testimony in the statement that is made part of the record that in fact there be a special treatment of all small businesses with under 10 employees, that that number 10 could perhaps be raised under Treasury regulations if the core concept were present, that is, if it were demonstrated that insurance costs, insurance arrangements are applicable with respect to, let us say, a 20-employee small business were different, and we have suggested at least one alternative test, but we continue to work on it.

Under the alternative test, the basic dollar limitations, the $10 and $25 limitation, would not apply if the small business in question had only one health plan, and made that core health coverage under the health plan available to 90 percent, and its nonhighly compensated employees; and the majority of those employees qualified under the plan, that participated under the plan.

The key with respect to that test is that to the extent that the $10 and $25 tests don't work and to the extent you get into more complicated rules as a result, the small business would have a simple way of complying with these rules.

Some of the other comments that we have at this initial stage—and I will stress again that we want to really be sure that we have got this right—are, first of all, with respect to the applicability of qualification requirement, one of the aspects of H.R. 1864 is that it really narrows the role of section 89. For example, group term life insurance is taken out of the core test.

We would suggest that a similar approach be adopted or considered with respect to the so-called qualification requirements. We would suggest that you consider applying them only to health plans. If you want to go a little bit beyond health plans, we would say that in any event these qualification requirements, the various paper requirements not apply to no additional cost fringe benefits, employee discounts, eating facilities, and things like that.

The final technical comment is with respect to the sanctions for failure to meet the qualification requirements.

When I'm talking about the qualification requirements, I'm talking about all the various requirements of a written plan, et cetera. As you know, one of the most highly criticized aspects of the section 89 before was the sanctions for failure to qualify, in part, had the effect of hurting the employees.

The response to that in H.R. 1864 is an excise tax on the employer equal to 34 percent of the amount paid or incurred under the plan if you fail to meet the qualification requirements.

We basically have two comments on this. We accept the basic excise tax approach, I think. First, we would suggest that the base for the tax simply be the cost of the employer providing the health coverage, not the actual valuation.

In this case, there is certainly a way to impose an ample penalty on the employer without requiring valuation in order to impose that penalty.

Second, and probably more important, we think that there ought to be some gradation in the penalties so that similar, for example, to the private foundation rules, perhaps there would be a 5 or 10 percent, or lower rate excise tax applicable initially so that the employer had an incentive to comply with it, and then if the employer still didn't comply within a certain period of time, you could go up to the larger 34 percent. We don't want people to be in a situation where they really don't have anything but a disaster to stop them from complying, keep them interested in complying with this.

We also think that a de minimis rule of some kind would probably be in order.

I would conclude by saying that we are—Congress and the administration—working very hard on trying to get section 89 replaced. I think that we all view this as a major priority at this point. I think the legislative debate really has been framed to a large extent by H.R. 1864. That's what we are analyzing, to make sure whether the core approach works. I am not able at this point to say that we are satisfied that we have done absolutely everything that we can to make this an approach that satisfies all our mutual goals with regard to simplicity, administrability, as well as the basic objectives under section 89.

But we are continuing to analyze it, and hope that we can mutually work together and resolve the outstanding issues. I would say, as Congressman Chandler said at the outset, and others have said, the one thing that is, I think, quite important for all of us to remember in doing this is that we are not going to be able to accommodate every person's objectives. We are not going to be able to accommodate every claim that is out there.

I think at the end of this whole thing we simply have to have something that we can comprehend that is reasonably simple to administer and that the great majority of the people, either under their current plans, or by modifying their plans, can comply with. We can't go through this process which started in 1986 and went through last year where we do try to accommodate everybody's interest and we end up with a monster.

With that conclusion, I'd be happy to take questions from anybody.

[The statement of Mr. Trier follows:]

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May 2, 1989

STATEMENT OF
DANA L. TRIER
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to be here today to present the Administration's views regarding H.R. 1864, which was introduced by Chairman Rostenkowski and others on April 13, 1989, to amend section 89 of the Internal Revenue Code. The Administration recognizes the enormous administrative burdens imposed on many employers by section 89. It is clear now that many of these problems were not fully understood when section 89 was enacted and that these problems cannot be properly addressed by regulations. Consequently, we agree with the Chairman that a complete revision of section 89 is necessary.

H.R. 1864 is intended to respond to many of the concerns taxpayers have expressed. The Administration applauds the efforts of the Chairman and the other sponsors of the bill to resolve the problems posed by section 89 and believes the bill sets the stage for legislative debate. We look forward to working with Congress during the course of the effort to develop a prompt legislative solution.

In the first part of my testimony, I will briefly describe the background of section 89, the policy rationale for its enactment and certain aspects of the proposed regulations. Then, I will summarize briefly the significant provisions of the bill. Finally, I will provide the Administration's preliminary views on certain provisions of the bill.

BACKGROUND AND POLICIES

The Internal Revenue Code generally provides that the value of employer-provided health coverage is excluded from income. Section 89, however, conditions the availability of this tax benefit by providing that employer-provided health coverage may be excluded from the income of highly compensated employees only if coverage is also provided on a nondiscriminatory basis to nonhighly compensated employees. In the event employer-provided health coverage is found to be discriminatory under section 89, the value of coverage is included in the income of highly compensated employees as wages. The specific features of section 89 and the regulations thereunder are summarized in the description of the bill prepared by the staff of the Joint Committee on Taxation (JCT pamphlet), and I will not repeat them here.

The rationale for the conditions imposed by section 89 was that the tax expenditure for the exclusion from highly compensated employees' incomes is justified only to the extent employers provide nonhighly compensated employees health coverage generally comparable in value to the coverage received by highly compensated employees. The legislative history of the Tax Reform Act of 1986 indicates that Congress was concerned that the rules formerly applicable to certain employee benefits, particularly health insurance, did not require sufficient coverage of nonhighly compensated employees as a condition to the exclusion; it was thought that the tax benefit afforded to highly compensated employees receiving employer-provided health coverage could not be justified without nondiscriminatory coverage being mandated.

In promulgating proposed regulations under section 89, the Treasury Department and Internal Revenue Service attempted to be as flexible as legally possible to assist employers in bringing their plans into compliance with section 89. Thus, the proposed regulations provide several transitional provisions intended to allow employers to comply more easily with section 89 in 1989. First, the proposed regulations provide that employers who reasonably and in good faith comply with section 89 and its legislative history in 1989 will be treated as having satisfied section 89. The proposed regulations further provide that employers who elect not to test whether their plans satisfy the 75 percent benefits test in 1989 may include in the income of certain of their highly compensated employees all of the employer-provided health coverage. The highly compensated employees who must include in income all of the employer-provided health coverage are the 20 percent of such employees who receive the greatest compensation from the employer, but not less than ten employees nor more than 2,000 employees. This transitional provision is extended to 1990, except that the number of highly compensated employees who must include all of the employer-provided health coverage in income is greater. Finally, under the proposed regulations, an employer generally may choose July 1, 1989, as the beginning of its testing year, and thereby ignore facts in existence prior to that date when testing its plans for compliance in 1989. Under this provision, an employer must annualize the benefits provided after July 1 to determine whether its plans are discriminatory.

Because we have become convinced that section 89 must be significantly restructured, the Department of the Treasury will do all it can to provide appropriate regulatory relief to minimize, within the confines of existing law, needless taxpayer compliance efforts under the current statute. In line with this policy, and in order to facilitate the legislative process, the proposed regulations will be modified to extend the beginning date for testing plans for compliance with the nondiscrimination rules in 1989 from July 1 to October 1. We hope that this step will provide Congress with sufficient opportunity to act before employers are required to expend substantial further resources to comply with the current statute.

SUMMARY OF H.R. 1864

H.R. 1864 responds to the perceived problems with section 89 in four ways. First, the complicated nondiscrimination tests of section 89 would be replaced by a two-part eligibility test and a benefits test. Second, certain modifications would be made to the categories of employees that must be considered for purposes of these tests, and the definition of highly compensated employees is changed. Third, the bill provides that the nondiscrimination rules applicable to group-term life insurance plans prior to the enactment of section 89 are to be applied to such plans, rather than the bill's new health nondiscrimination rules. Finally, while the bill would retain the so-called qualification requirements set forth in section 89(k), the sanction for failure to satisfy such requirements would be changed to an excise tax on the employer.

A. Nondiscrimination Tests

The first part of the eligibility test requires an employer to provide to at least 90 percent of its nonhighly compensated employees health coverage that is primarily core health coverage, at a cost to an employee of no more than $10 per week for employee coverage and no more than $25 per week for family coverage. The second part of the eligibility test requires that no health plan of an employer discriminate with respect to eligibility (by its terms or in operation) in favor of highly compensated employees. The JCT pamphlet states that the second part of the test is intended to preclude executive-only plans. The description further states that if at least 50 percent of the employees eligible to participate in the plan are nonhighly compensated employees, the plan is not an executive-only plan.

A health plan that satisfies both parts of the eligibility test is a "qualified core health plan." If the employer's health plans are not considered, in the aggregate, to be a qualified core health plan, each highly compensated employee must include in income all of his or her employer-provided benefit.

If an employer's health plans pass the eligibility test, a portion of the value of the employer-provided health coverage must be included in the income of a highly compensated employee if such coverage does not satisfy the benefits test. The benefits test limits the amount of the tax-favored health benefits a highly compensated employee may receive to 133 percent of the value of the employer-provided coverage taken into account to satisfy the eligibility test.

B. Employees Taken Into Account and Definition of Highly Compensated

Under current law, the definition of a highly compensated employee is the same as that used for other employee benefits. The Internal Revenue Code generally defines a highly compensated employee as any employee who, during the current year or the prior year, is one of the following: (i) a 5 percent owner; (ii) an officer receiving compensation in excess of $45,000; (iii) an employee receiving compensation in excess of $75,000; and (iv) an employee receiving compensation in excess of $50,000, who is among those 20 percent of employees receiving the greatest compensation from the employer. The Code provides that the relevant dollar amounts will be indexed for inflation. In addition, an employer must have at least one officer who is considered a highly compensated employee, regardless of that officer's compensation. The bill modifies the definition of a highly compensated employee by providing that officers with compensation in excess of $45,000 are the only officers who must be considered highly compensated employees.

Under current law, an employer, when testing its health plans, generally may exclude those employees who have not completed six months of service, those who are not yet age 21, those who normally work less than 17 1/2 hours per week, those who normally work not more than six months per year and nonresident aliens receiving no United States source income.

The bill preserves the rules regarding minimum age and service conditions and nonresident aliens, but changes the definition of part-time employees and provides special rules for leased employees and employees covered by collective bargaining agreements. Part-time employees are those who normally work less than 25 hours per week. A leased employee generally may be considered an excludable employee if the leasing organization certifies to the employer that core health coverage is available to the leased employee at a cost that is no higher than $10 per week ($25 per week for family coverage). Finally, although the bill is somewhat unclear on this point, it appears that employees who are covered by a collective bargaining agreement may be disregarded in testing the health benefits available to an employer's other employees. Similarly, other employees may be disregarded when testing the health benefits provided to employees covered by collective bargaining agreements.

C. Plans Covered

Under present law, group-term life insurance plans are subject to the section 89 rules, as well as health plans. In addition, an employer can elect to test certain other employee benefit plans, such as dependent care assistance programs, under the nondiscrimination rules of section 89. By contrast, the bill subjects only health plans to its new nondiscrimination rules and provides that the nondiscrimination rules in effect prior to the Tax Reform Act of 1986 will apply to group-term life insurance.

D. Sanction for Failure to Meet Qualification Rules

The bill replaces the current law sanction for failure to meet the so-called qualification requirements with an excise tax on the employer. It is unclear what amount is subject to the tax. The bill provides that the excise tax is to be equal to 34 percent of the amounts paid or incurred under the plan, similar to the present law requirement regarding the amount to be includable in an employee's income for such failure. The JCT pamphlet states the excise tax is to be equal to the cost to the employer relating to the coverage that failed a qualification requirement.

COMMENTS ON H.R. 1864

The Administration believes that the bill represents a positive step toward simplification of the rules applicable to employer-provided health and other benefits and, in particular, endorses its movement toward a design-based method for testing plans for nondiscrimination. We are especially pleased that H.R. 1864 would eliminate much of the data collection and recordkeeping requirements of current law.

The Administration has not fully completed its review of the bill, and further time is necessary to explore fully the bill's practical impact. It is necessary to determine precisely how the tests will operate in the context of the wide variety of circumstances faced by employers, and, in particular, to assess the relationship between the tests and employees required to be considered. We are, however, prepared to make several preliminary comments at this time as to the areas that we believe need further consideration or clarification.

A. Nondiscrimination Tests

1. Eligibility Test

The foundation of the bill's eligibility test is the required availability of a health plan providing "primarily core health benefits" at a cost to employees of no more than $10 per week ($25 per week for family coverage). The dollar amounts are indexed in accordance with the social security average wage index. It should be noted that, historically, health costs have been increasing more rapidly than wages. Although the bill does not define the term "core benefits," the JCT pamphlet states that major medical and hospitalization benefits are core health benefits and that dental and vision benefits and any health benefit provided under a salary reduction arrangement are not core health benefits.

The Administration believes employers should be permitted flexibility in choosing the types of health coverage they offer to their employees. The bill's provision for "primarily core health benefits" achieves this goal. Nevertheless, we agree with the JCT pamphlet that dental and vision benefits should not be considered core health benefits and urge Congress to provide in the statute itself that such benefits are not core health benefits.

The purpose of the dollar limitations on the amount an employer may require an employee to pay for qualified core health coverage is to ensure that affordable core health coverage is available to employees. The advantage of dollar limitations is to enable an employer, on an objective basis, to determine if it is offering health coverage to employees on a nondiscriminatory basis. At the same time, it is also important to assure that any dollar limitation does not reduce the availability of employer-provided health benefits.

To ensure health coverage remains affordable, the bill provides that the dollar limitations are indexed in accordance with the social security average wage index. The Administration supports the effort to make affordable health coverage available to employees and understands affordability is the rationale underlying the designation of a wage inflation index rather than a health care costs inflation index.

However, the impact of this method of indexing on employers' costs and on the overall cost of health coverage is not known. For example, it is uncertain whether the wage index would have the effect of increasing employers' costs, increasing co-payments and deductibles, or decreasing the quality of health coverage offered to employees. As a result, the Administration is not prepared at this time to state that this index is the best method of indexing the dollar limitations or that other affordability tests should not be considered. We will work with Congress to determine the proper approach as soon as practicable.

The second part of the eligibility test provides that the plan may not contain any provision relating to eligibility to participate that discriminates in favor of highly compensated employees. As noted above, the JCT pamphlet indicates that this test will not be met unless at least 50 percent of the group of employees eligible to participate in the plan are nonhighly compensated employees. This rule should be modified to provide that a plan would be treated as satisfying the second part of the test if the percentage of highly compensated employees eligible to participate is no greater than the percentage of the nonhighly compensated employees eligible to participate in the plan. Absent such a change, an employer with a workforce comprised of a relatively large proportion of highly compensated employees might not be able to satisfy this part of the test.

2. Benefits Test

Under the benefits test, the value of the health benefits actually provided to a highly compensated employee that is more than 133 percent of the value of the benefits available to nonhighly compensated employees under a qualified core health plan is included in income. This test is simpler than the benefits test in section 89 because an employer is not required to keep records of the health coverage received by nonhighly compensated employees.

Nonetheless, the problem of health benefit valuation remains. The bill provides that value shall be determined under tables prescribed by the Secretary of the Treasury. The JCT pamphlet provides that until regulations are developed an employer may use any reasonable valuation method, including the cost of the premium as determined under the continuation coverage requirements applicable to group health plans.

Section 89 also directs the Secretary of the Treasury to prescribe health valuation tables. Employers argued that until valuation tables were developed, section 89 could not be implemented. Amendments to section 89 made by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and the recently promulgated proposed regulations provide that any reasonable cost valuation method may be used to value benefits and that the cost of health coverage for purposes of the group continuation coverage requirements of section 4980B is deemed a reasonable cost valuation method. TAMRA and the proposed regulations provide that COBRA cost is a reasonable valuation method because the Treasury Department, despite considerable efforts, could not timely develop accurate, reliable valuation tables.

The Treasury Department believes it is in no better position today to develop valuation tables than it was when section 89 was enacted. Consequently, we urge Congress to provide in the statute that the value of health coverage is its cost or any other reasonable valuation method that the Secretary of Treasury may provide in regulations. This would provide certainty to employers and allow the Treasury Department to study further whether it is feasible to develop tables. To assist the Treasury Department in developing these tables, we request Congress provide appropriate authority and direction to other federal agencies that collect data regarding health care to share such data with the Treasury Department for use in the developing valuation tables for health benefits.

3. Salary Reduction Contributions

The bill provides that salary reduction contributions are treated as employee contributions for purposes of determining whether the employee-paid portion of the premium exceeds $10 per week ($25 per week for family coverage). For purposes of determining whether health benefits provided to highly compensated employees exceed 133 percent of the qualified core health benefit provided to nonhighly compensated employees, salary reduction contributions are treated as employee contributions in the case of nonhighly compensated employees and employer contributions in the case of highly compensated employees. The JCT pamphlet states that salary reduction contributions are treated in this manner because they are truly a cost to the employee, and in a real sense are more costly for nonhighly compensated employees.

Although the Administration recognizes the policy reasons underlying the bill's treatment of salary reduction contributions, it believes the treatment of salary reduction contributions for purposes of the nondiscrimination rules needs further study. In particular, the treatment of such contributions for purposes of the benefits test should be examined to determine if there is an equitable way to treat such contributions made by highly compensated employees as employee contributions if, in fact, nonhighly compensated employees are receiving the same health benefits as highly compensated employees.

B. Small Business Considerations

The special circumstances faced by small businesses should be addressed in any legislation enacted to modify section 89. Businesses with less than ten employees often cannot purchase health insurance at group rates. Moreover, many small businesses have insurance contracts that do not provide for coverage for employees working less than 30 hours per week.

Congress should consider alternative ways in which small businesses that cannot purchase health insurance at favorable group rates may comply with the nondiscrimination rules. We believe the bill does not provide a satisfactory alternative for these businesses. For example, the $10 cap on the amount an employer may require an employee to pay for health coverage under a qualified core health plan may cause such businesses problems if any employee has health problems or if the employer's workforce is comprised of employees of significantly different ages.

The Administration suggests, therefore, that Congress consider permitting small businesses to satisfy the nondiscrimination rules under alternative tests. A small business for this purpose would generally be defined as a business with ten or fewer employees. However, an employer with a larger number of employees could, under rules developed by the Secretary of the Treasury, be granted similar relief to the extent it was found that the employer faced similar circumstances in purchasing insurance.

We offer for your consideration this alternative. The dollar limitations on the employee-paid portion of the premium would not apply if: (i) a small business has only one health plan; (ii) the small business makes core health coverage available to 90% of its nonhighly compensated employees; and (iii) a majority of the nonexcludable, nonhighly compensated employees eligible to participate in the plan actually do so.

Many small businesses have insurance contracts that do not provide for coverage of employees who normally work less than 30 hours per week. The Administration believes it is advisable not to require employers with such contracts to make available health coverage to employees working less than 30 hours per week until the expiration of the current contract term.

Still other alternatives may be developed. The Administration urges Congress to consider all viable proposals that would enable such businesses to comply with whatever form the nondiscrimination rules may take in future legislation.

C. Applicability of Qualification Requirements

Congress should consider applying the qualification requirements only to health plans. This approach is sensible if the nondiscrimination rules are applicable only to health plans. Even if Congress rejects this approach, the Administration recommends that the qualification requirements not apply to no-additional-cost fringe benefits, employee discounts and employer-provided eating facilities. These fringe benefits are adequately addressed in section 132 and the regulations thereunder. Moreover, it is questionable, for example, whether employers should be required to maintain an employee discount program for an indefinite period of time or that an eating facility should be maintained for the exclusive benefit of employees.

D. Sanctions for Failure to Meet Qualification Requirements

H.R. 1864 replaces the current sanction for failure to comply with the qualification requirements of section 89 from an inclusion in employees' incomes of the values of the benefits provided under the plan to an excise tax on the employer equal to 34 percent of the amount paid or incurred under the plan. We whole-heartedly agree that the sanction for failure to comply with these requirements should be imposed on the employer who caused the failure, not on employees.

Nevertheless, we perceive two problems with the proposed excise tax. First, it should not be applied to amounts paid or incurred under the plan. Such a provision would require an employer to know all of the health benefits provided under the plan to its employees during each year and the value of each benefit. The Administration recommends that the base to which the excise tax would apply be adopted in accordance with the description in the JCT pamphlet, i.e., the cost to the employer of providing the health coverage.

Second, we believe that a 34 percent excise tax may be too high. Consideration should be given to a two-tiered excise tax similar to the two-tiered excise tax imposed on certain transactions involving private foundations. Thus, a lower rate excise tax would be applied for each year in which the failure exists. If an employer did not correct the failure within a reasonable time after the failure is discovered, a higher excise tax would apply.

In addition, an employer may inadvertently fail to comply with one of the qualification requirements. For example, the employer may fail to provide a small number of its employees with the required notice of material plan terms. For this reason, any legislation that may be enacted should provide rules for de minimus failures or should give the Secretary of the Treasury authority to provide for such rules in regulations.

CONCLUSION

The Administration agrees that prompt Congressional action is needed to alleviate the problems employers are experiencing in complying with section 89. We believe the bill represents a major step forward in achieving these goals, but we are continuing to analyze the approaches taken in the bill to determine whether they represent the best solutions to the various issues posed. We are convinced that in order for any legislative response to be effective the statute must be made comprehensible and simple to administer. We are confident that through the legislative process our mutual goals can be achieved and the outstanding issues resolved.

This concludes my prepared remarks. I would be pleased to respond to your questions.

Mr. PICKLE. We thank you, Mr. Trier. I would first say we appreciate your testimony, and to remind you and our guests that the chairman thinks that the bill we have introduced now, H.R. 1864, is a well-intended bill and is not just offered as a fishing expedition but, rather, to address some of the complaints that we have heard. And I hope that we can stay with it.

I assume from your testimony that you think this is a good step, it is an improvement; and while you do not voice any opposition to any one aspect, I notice you have said give some consideration to small business and raise other questions. But, in general, they are just concerns to examine rather than in opposition to.

Now, my first question to you is this: The first part of the eligibility test requires an employer to provide at least 90 percent of its nonhighly compensated employees to be covered. One of the concerns that has been expressed to me is: How does a company or an employer comply with the 90 percent, an arbitrary figure? Is there any room, wiggle room, we will say?

The original bill that Mr. Rangel once introduced I think provided for 100 percent; now, we have gone down to 90. Is there some way to approach this arbitrary figure and still prevent a cliff from occurring if it goes to the 89 percent? Can you comment on that? Do you have any suggestions for us?

Mr. TRIER. Obviously, I think it is a very important question and one that we are aware of. I think it really has two parts to it. One is whether the 90 percent test, together with the types of employees that you can exclude, constitute a fair amount of wiggle room consistent with Congressman Rangel's and others' desires to cover quite a substantial number of employees. So the first question is whether there is enough wiggle room.

As to the second question, something that a lot of people have pointed out during this last 2 weeks, which is if you have got 89 percent you are out of compliance completely, we do not have a perfect solution to that. We are continuing to analyze that question. In honesty, my candid response to it is that I am somewhat skeptical about—speaking really for myself as a tax technician addressing that issue—that there is any perfect response to the cliff nature of these tests that does not introduce again all the complexity that we had before. That is, if you end up, as some people suggest, with all average benefit tests or whatever is a fail-safe—which we are considering. We are considering a response to the cliff problem. But if you start introducing too many other alternative tests to the 90-percent cliff, you get into the situation which we now have of a 15-page statute, a very difficult task to write regulations under it in the complexity we now face.

So I am going to have to say we have no solution to that problem at this point, Congressman Pickle.

Mr. PICKLE. Well, I still think that is a problem to be addressed.

Mr. TRIER. Absolutely.

Mr. PICKLE. Perhaps in a report or somewhere we can say what reasonable people would say would be a compliance figure.

Now, you have stated you would give some consideration to small business. Would you make any recommendation about State and local government employees?

Mr. **Trier.** I do not believe we are prepared to give any specific response to the State and local government employee situation. We are continuing to analyze that issue.

Now, some aspects of the chairmen's proposal are responsive, in part, to the State and local government employee situation. For example, the highly compensated definition change, so that you are only considering officers or whatever above $45,000, is somewhat responsive. At this point, I do not think we are prepared to say that they should be subject to a special exception.

Mr. **Pickle.** Thank you.

Mr. Archer.

Mr. **Archer.** Thank you for your testimony. I think it is very constructive.

I just have one question, Mr. Chairman, and that is whether the Treasury can provide this committee with some data that so far we do not have. We are told that the annual cost of the tax exclusion relating to employer-provided health benefits is estimated at roughly $32 billion per year. I wonder if the Treasury could break this total down and separate out the total amount of the exclusion related to employees covered by collective-bargaining agreements, and the plans provided for Federal, State, and municipal employees, so that we can get what, in effect, is the non-collective-bargaining section of the private sector, the collective-bargaining section and the part that relates to the public sector. I think that would be very helpful to this committee.

Mr. **Trier.** Certainly, I am unprepared to address that right now, but we will immediately address that issue to the extent we can and provide that information to you, Mr. Archer.

Mr. **Archer.** About how long do you think it would take to get that data for us?

Mr. **Trier.** I would have to talk to the revenue estimating staff to give you a clear idea. I am absolutely certain that they have got the general information, but they do not have as good a data in this area as they would like. But I think I can talk to your office by this afternoon to——

Mr. **Archer.** Oh, that would be great because we will be moving ahead rapidly with this legislation, and it would helpful to have that.

Mr. **Trier.** Right.

Mr. **Archer.** Thank you.

Mr. **Pickle.** The Chair will recognize Mr. Downey.

Mr. **Downey.** I have no questions.

Mr. **Pickle.** The Chair recognizes Mr. Pease.

Mr. **Pease.** No questions.

Mr. **Pickle.** The Chair recognizes Mr. Frenzel.

[No response.]

Mr. **Pickle.** Mr. McGrath.

Mr. **McGrath.** Mr. Chairman, today, in BNA, there was some concern about whether or not 501(c)(3) organizations that provide sheltered workshops for the retarded should be exempted from section 89. Does the Treasury have any clear indication of what they may do in regard to this?

Mr. **Trier.** We have not addressed that issue at all. I would think that it is difficult to start making specific exceptions like that. In fact, I think this morning is the first time that the issue was brought to my attention.

Mr. McGrath. Thank you, Mr. Chairman.

Mr. Pickle. Now the Chair recognizes Mr. Anthony.

Mr. Anthony. Thank you, Mr. Chairman.

I have four areas that I would like to get into. The first deals with the eligibility test in the bill. I want to know what your viewpoint would be on what are the problems with indexing the $10, $25 maximum allowable employee contribution to the Social Security wage base; and then what would be a better index or should the employee contributions be reflected as a percentage of total premiums.

Mr. Trier. I will take both questions. First, on the Social Security wage base index issue, Congressman, I do not think that we know at this point whether that would work better than all alternatives. As I said in my testimony, we understand very much why H.R. 1864 adopted the particular way that this index is split. We are quite concerned that if it is not in some ways an index that is responsive to increases in health costs, et cetera, that it may at some point lead to a distortive effect in the decisions of the parties. For example, if they got up against the index, you may have—how does the employer respond? Does he quit providing the availability? Does he ask that there be more of a deductible? Is there more of a contribution by the employee?

So we are continuing to analyze those issues. We think it is a difficult, technical issue. That is one reason I want there to be some room for error in it. But I have no firm position on that now.

As to the percentage issue, I am kind of going to state what I believe your point is. The question is whether as an alternative or as a replacement for the current tests, which are the $10 and $25 cap, whether instead you would say that so long as the employees did not have to contribute over a certain percentage of the cost, that you would be viewed as having available health coverage.

Well, as I am sure is implicit in the bill, at some point, at some level, a percentage test only could lead to a problem. The core rationale for this approach, this availability approach or design-based approach, is that, in fact, it is really available. So if you wanted to think of an extreme case, and we should not make our legislation only by extreme cases, if you want to make an extreme case that if you said that so long as you only required the employee to contribute a third, you would be fine. But then you have a piggish employer out there who says it is a third, but it is a third of $1,500 or, you know, some gross amount. So that, in fact, the smaller income employees could not get to that third or could not, as a practical matter, contribute. You would not have the test working properly.

That does not mean that we are not analyzing percentage tests as some alternative under some circumstances.

Mr. Anthony. If you would yield, you have used the word that I was hoping that you would use; that is, health inflation. The record will clearly show that if we are not careful, we will be back with another hearing on another problem because of the rate of health inflation. That was the purpose of asking the question. So since you are looking at it and studying it, that does satisfy me.

Quickly, I would like to go through the three other areas that I have. Under section 89 you have a 90-percent eligibility test. This can lead to some peculiar results. For example, a plan may require no employee contributions, but if it is only available to 89 percent of the nonhighly compensated employees, the plan will fail. It is the cliff problem.

I was just curious how you felt about giving employers an option to use the eligibility test or a coverage test.

Mr. TRIER. Well, as I responded to Congressman Pickle, I think the cliff issue is a real issue with respect to this bill. I think another way of stating the issue, as implicit in your question, is that it is really stark when you feel that all the basic—when, in fact, if you gave it to 89 percent of the people, you may be covering more people than somebody that met the 90-percent test but the employees had to contribute. So that really does make the point very clearly.

For that reason, we are considering ourselves whether—let us say one alternative to the 90-percent test would be appropriate in this context. The fear I would like to continue to express, though, is that we do not want to get back to the situation where we have four core tests and three alternatives to each test, et cetera. We do not want to go down that road too far.

It may, in fact, be true in the case you present that one alternative easily understood and easily complied with would be an appropriate response, but I do not want to make that a habit and get back into a 14-page statute again.

Mr. ANTHONY. Mr. Chairman, my time has expired, but I have two questions. I would like to cut that to one if you will give me permission to ask one other question, because it does pertain to kind of an anomaly that has been created. There is a confusion between the current law and the proposed bill. With your permission, just one final question.

Mr. PICKLE. Is the gentleman asking for additional time?

Mr. ANTHONY. Additional time for just one additional question.

Mr. PICKLE. The gentleman is recognized for one additional minute.

Mr. ANTHONY. Thank you, sir.

What is your viewpoint about a company that has gone to the trouble and the difficulty to comply with the current law, and then finds that it is out of compliance simply because H.R. 1864 does not allow cafeteria plans? What can we say to a company or a multitude of companies that are caught in that type of a situation?

Mr. TRIER. Well, as you know, their problem under the bill would start next year, because this year you are given the option between current 89 and H.R. 1864 under the legislation.

My tentative reaction to this—and this is something, again, that has been brought to our attention and that we are thinking about—is that, as I said in my testimony, the real question is: What should the right rule be for cafeteria plans? We are not convinced at this point that we have the appropriate solution to it. I myself would be, for a variety of reasons, somewhat reluctant to endorse the concept I think that is implicit in your question, which would be to have a two-track system, in essence. All of 89 in its greater glory today plus——

Mr. ANTHONY. If you would yield, these are all very complex, and obviously impossible to answer within the time constrictions that we have. I do have a very detailed example here, and what I would like to do is to submit it to you and then just have you respond back for the record in writing on this particular area. I will also submit the fourth question to you in writing, which basically is how in the world are those people going to comply to the end of the year, because we are now into our third rewrite of section 89. I would like to get some indication from the administration on how they feel about giving some relief or intent to comply with the business community.

[See followup letter on p. 60.]

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. PICKLE. Thank you, Mr. Anthony.

It will be the Chair's intention to recognize other members, after we have complied with the 5-minute rule with all the present members, at the end of the first round.

Now the Chair recognizes Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Let me ask you about the part of your testimony that dealt with small business considerations. What about considering a flatout small business exemption for section 89? You know, when we take a look at minimum wage, we have a $500,000 exemption; the proposal for parental leave has a 50-employee-or-less exemption. What would the administration's position be if some of us offered an exemption for small businesses below a certain level?

Mr. TRIER. Well, first of all, as is obvious from our discussion on the small business situation, we continue to analyze alternative ways of dealing with small businesses. At this point, I would say, though, that we would be reluctant to support a flatout exception for any class of employers. I would personally think that the best way to address their problem—and you can imagine, although it is not a common situation, that there are situations with small businesses of 10 or fewer employees where you have got a health insurance policy just for the 3 fat cats and none of the other 7, but you do not really think it is appropriate that they should get the tax benefits.

With that said, we clearly understand the special situation of small businesses and are continuing to work on relaxing the rules for them.

Mr. DORGAN. You also understand that on the main streets I come from, if you have got a business with 10 or fewer employees, it is unlikely that you will find 3 fat cats i~~n that bu~~siness.

More typically, small businesses in our part of the country are struggling to hang on by their fingertips to stay open, and the question I pose is: Should we be confronting them with more and more accounting here? Is there a compelling reason to not have a basic exception of the type we have had in most other initiatives here in Congress of this type? Should we not consider a small business exception?

I guess you are saying the administration would be opposed to that?

Mr. TRIER. I am not prepared to say that now, but I do think we would only come to that conclusion reluctantly.

Mr. **Dorgan**. If one would be opposed to that, is it because you think that, generally speaking, small businesses of, let us say, 50 or less or 10 or less employees, whatever the definition might be, that there exists in those categories of businesses substantial abuse?

Mr. **Trier**. No. I really do not think that—I think that it is unfair to say that. I think that the real question is whether or not there is a compelling case for them not to be subject to some basic inducement to cover more people, or some level of rule that stops those few people who do abuse it. I do not think there is compelling evidence that they abuse it. As a matter of fact, because of the requirement of getting a group, you know, there may be some natural impetus for them to cover more than a few people and, therefore, a larger proportion of their corporate base in any event.

Mr. **Dorgan**. Well, let me say I understand the objectives of section 89, and they certainly are laudable objectives. You know, I will support that.

My question is: If the makeup of the business community is that at the bottom you have literally millions of small businesses with few employees, without a lot of gross revenue, just kind of making a living, in some cases just hanging on, if there is not substantial abuse in that area, you wonder whether you ought to subject those millions to substantial accounting requirements and substantial tests here. Even if we passed the modifications that simplify it, the question is: Should we not proceed here just as we have done in minimum wage and other areas. There are a group of employers out there that are just flatout small businesses that are not in the business of keeping books for all of these purposes. Frankly, they do not have the capability of hiring extra people to do all this sort of thing.

I guess what I would like to find out from you, if you can, is what would be the compelling reason to subject those millions of small businesses, very small businesses to these rules if, in fact, there is not a substantial abuse there. Could you get some information and send it on to us based on what your knowledge is down at Treasury of these small businesses and why we should not consider a small business exception or exemption.

Mr. **Trier**. OK. I will try to formulate a response to you in a clear way.

[Treasury was unresponsive to congressional inquiries.]

Mr. **Dorgan**. I might just say to the chairman that this is an area a lot of us are concerned about. We understand that 89 is going to be around and going to be improved, but a good many of us would, I think, like to suggest a small business exception.

Thank you, Mr. Chairman.

Mr. **Pickle**. Now the Chair recognizes Mr. Crane of Illinois. Mr. Crane is also scheduled to appear as a witness, and the Chair will try to reserve his right. He must go to the floor. But if the gentleman from Illinois wishes to be recognized now, he can be recognized.

Mr. **Crane**. No.

Mr. **Pickle**. All right. The gentleman passes.

Now the Chair recognizes Mr. Chandler.

Mr. **Chandler**. Thank you, Mr. Chairman.

In the proposed draft of H.R. 1864, under requirements it says, "In general, for purposes of this section, a health plan must meet the requirements of this section if"—and A is the one if that I think has not been discussed very much. And I would like you to talk about it. That is, "such plan does not contain any provision relating to eligibility to participate which by its terms or otherwise discriminates in favor of highly compensated employees."

Can you tell me what that means? And how much regulation is it going to take to describe that? Is this where the camel gets its nose under the tent? Should we pay more attention to that in this committee and define what we mean by provisions that discriminate?

Mr. **Trier**. I would like to react to that by saying I have some of the same fears you do. I think that the Joint Committee pamphlet, as you know, gives some content to that reasonably vague language. It indicates that that test will not be met unless at least 50 percent of the group of employees eligible to participate in a plan are nonhighly compensated employees, thereby sort of bringing back in tests similar to what you had under section 89.

We specifically do not think that that particular test should be the only alternative way that this language is meant. But I would also like to say that personally I agree with you that we should confront what the meaning of this provision is very clearly at this point, and not permit it to be the nose of the camel under the tent.

I had exactly the same fear. I do not want us to be in a situation where, for one reason or another, we are, in essence, writing 30 pages of sort of common law of what this sentence means that really ends up making the regulatory provisions much more complicated.

In fact, we considered testifying to that effect. So I think it is a good question.

Mr. **Chandler**. I want to follow up, and Mr. Anthony did not have time to have his question answered. He said he was going to submit it in writing, but I would like to hear your comments on the point. Specifically, if we pass legislation this year amending section 89, will Treasury be able to promptly provide regulatory relief for employers that attempt to comply with the new law and current law?

Mr. **Trier**. I think there are really two steps in addressing that question, which I think is a very difficult question. The first is, let us presume for the moment that what we have is something like this bill that replaces the legislation for this year. I would think we would continue to take the approach that we have taken before, which is that the law is on the books. At some level, we have to treat that as the law is on the books, but that we would be as accommodating as we possibly can, consistent with the fact that the law is on the books.

There are really two things at its core that we do, or maybe three. The first is continue to have a rule that good-faith compliance with the concepts is enough, as opposed to one little "i", two little "i" out of the regs.

Second, as Secretary Brady announced yesterday and as I have stated again today, within the framework of enforcing the law that is on the books, moving, for example, the required start of the first short testing year to October 1, that type of thing and things that are consistent with that, we are continuing to analyze.

The third is perhaps within the interstices somewhere, we can come up with some even blunter safe harbors for this year.

That does not remove the problem completely—I mean, I am too intelligent to think that that is fully responsive to the problems that the employers have. I think we have gone a long way, but just the fact that as they are planning now, they do not know what statute is going to be in effect is not a good thing.

Mr. CHANDLER. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Rangel.

Mr. RANGEL. I have no questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mrs. Kennelly.

Mrs. KENNELLY. Yes, sir, thank you for your testimony.

Since we have had some discussion that State and local governments are different than general business concerns, have you looked at that in the context of new recommendations in the new bill? Will there be special exceptions made for State governments?

Mr. TRIER. For some reason, I could not hear the first part of your question.

Mrs. KENNELLY. Knowing that State and local governments are obviously different from private enterprises——

Mr. TRIER. Right.

Mrs. KENNELLY. Will there be some special provisions for State or local governments in the new recommendations?

Mr. TRIER. I cannot say that we would make such a recommendation. In H.R. 1864, there are some provisions that do not pick them out, but that are responsive to their situation. And we are continuing to analyze whether, in fact, like small businesses, there are some special circumstances that merit——

Mrs. KENNELLY. But you will keep those special concerns in mind?

Mr. TRIER. Sure. Absolutely.

Mrs. KENNELLY. Thank you, sir.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Trier, in the separate test of business, the separate line of business test, should we construct a separate test with more emphasis on the benefits and activities of the separate business, rather than the benefits provided by the parent company?

Mr. TRIER. I am not absolutely certain of the facts, but I believe that would be accommodated under H.R. 1864.

Mr. COYNE. You would not recommend any addition to what has been provided?

Mr. TRIER. Well, I am not prepared to say that we would recommend that at this point.

Mr. COYNE. OK. Thank you.

Chairman ROSTENKOWSKI. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

In my experience, particularly over the last few years as we have made many changes in the requirements for businesses that provide health benefits to their employees, I have seen more and more small businesses discouraged by the requirements that Government is placing on them, and particularly in light of the increasing costs of health care and in the light of the increasing costs of the legal fees associated with restructuring a health plan every year as Congress makes some new requirement.

In that context and in the context of your earlier comments that there really is no evidence that small business is guilty of discrimination, I can hardly believe that we might create this amount of paperwork on the back of our small businesses to prevent what might possibly happen in a few instances. In my estimation, we are going to cause a lot of small businesses to simply be unable to provide health benefits.

Now, first of all, you have already answered my question about what evidence of discrimination exists among small businesses, but, really, what is wrong with the approach of judging nondiscrimination by the provision of access rather than by the provision of participation, particularly when for small businesses their employees are often variously dependent on benefits provided by their small employers? Often, there is a spouse or another family member who is employed by a much bigger employer who carries the health benefits that the family depends upon.

So I would ask you, why can't we just for the smaller businesses use the old rule of access rather than the new rule of participation?

Mr. **Trier**. I think this comes down to a philosophical question. First of all, I would not foreclose in my own view something that is perhaps even more access-related than the alternative proposal we have made. As I described it earlier, we would suggest that the rules would be much less detailed with respect to small businesses, but there would, in fact, have to be a requirement that the majority of the nonhighly compensated employees in fact participated.

I would not foreclose going to a pure availability test, but——

Mrs. **Johnson**. Why? My question is: Why do you oppose the availability test?

Mr. **Trier**. I did not say I opposed it. I said I would not foreclose going to it. But the reality of provision of benefits to employees is obviously what we are after here. And availability does not mean available if it is, in fact, as a factual matter, not available.

Now, the response of H.R. 1864 to that is to put a cost limit on exactly how much is required to participate in the plan. The alternative to that, which is, in a sense, pure availability, is to go to a rule which they do not have to worry about the cost limits but, in fact, would look at whether people actually participated.

We are looking at both types of approaches. We have not foreclosed that, but the cost of something that is pure availability is that the tax expenditure does not necessarily serve its purpose of extending coverage to people, which is one of the articulated reasons or the tax benefit that is given.

Mrs. **Johnson**. It is one of the articulated reasons, but however, there is no real evidence that this is the problem in the small business sector that I have been able to discover. So anything along that line you could provide me with, I would be happy to review.

Also, collective-bargaining agreements are a concern of ours. Why cannot we do something much, much simpler for those businesses whose employees are covered by collective-bargaining agreements, where, at the table, they may have foregone something in order to get something else. That concerns me.

Would you support exclusion of collectively bargained employees?

Mr. TRIER. I am not sure exactly where your question is leading. Outright exclusion in all circumstances, or——

Mrs. JOHNSON. You would have to have some general relationship between those covered and those not covered by collective agreements—but there ought to be a much simpler rule that we could develop for situations where there are collective agreements, and especially where there might be regionally very different collective agreements, but appropriate to that region and collectively bargained by the leaders in that region.

Mr. TRIER. OK.

Mrs. JOHNSON. This is the kind of concern that I have, and thank you.

Chairman ROSTENKOWSKI. Mr. Moody.

Mr. MOODY. Thank you, Mr. Chairman. I take it then, you are basically supporting the bill. Is that accurate?

Mr. TRIER. I do not believe that is entirely accurate. I think it is accurate to say we think it is a very major important step toward achieving the goals that we want. We are continuing to analyze whether, in fact, it has gone as far as it can, and whether it works perfectly in practice.

Mr. MOODY. All right, let me rephrase it. You believe it is an improvement over current——

Mr. TRIER. I think it is more than an improvement.

Mr. MOODY. A major improvement.

Mr. TRIER. A major improvement.

Mr. MOODY. Right. In other words, you reserve——

Mr. TRIER. We are very enthusiastic about this step.

Mr. MOODY. Right. In other words, you reserve the right to maybe suggest some additional improvements?

Mr. TRIER. We are analyzing it carefully. We want to make sure this is our last time we deal with this.

Mr. MOODY. Let me ask you two big questions. First, and I am asking this as a supporter of the bill myself, what about the proposition of simply abolishing tax excludability of fringe income above some certain thresholds? Let us say some reasonable number for health and other benefits, and then do away with all the paperwork.

So if you want to provide a Cadillac-style health program to your employees, that is fine. I do not know what a reasonable amount would be—but you would index it. Above that figure, you would simply add to the base of income. It would be a base broadener, and you would simply pay taxes on it. What would be wrong with that?

I know that sounds dangerous having it said simply, but what would be wrong with that?

Mr. TRIER. Well, first of all we have considered all of the various approaches. One of them that is always considered is the role of a cap.

As you know, there is very strong disagreement about a cap of the type you—there are a lot of people who are opposed to it. I noticed in Chairman Rostenkowski's opening statement, the problem that he expressed was—just taking your Cadillac plan as an example—is that you have not necessarily achieved the goal of covering more people.

The other thing that most people point to with respect to a cap is you have various problems in, you know, different geographical areas and whatever. So at this point, we would be unable to support that and really are viewing this bill as the framework for analysis, but all possible options are being considered.

Mr. MOODY. My second question is, this bill only deals with health benefits. Would you use this approach, assuming we could work it out with your cooperation, as a forerunner to a similar approach for other fringe benefit taxation?

Mr. TRIER. Well, as you know, in a way, this bill represents a step back to the old days where different types of benefits are treated in different ways, and I think the basic notion of availability and design base may be something that we want to keep in mind when we are addressing other benefits.

But I think one of the lessons we have learned here is that health benefits are—and I suppose it is true with others—but health benefits are a peculiar animal and that we have to be very careful when we are applying, quote, uniform nondiscrimination rules, close quote, to all these various benefit programs, that we do not make it impractical.

Mr. MOODY. Thank you.

Mr. TRIER. Thank you.

Chairman ROSTENKOWSKI. Mr. Secretary, you observed that you do not know whether you are for the legislation. How do you stand on repeal?

Mr. TRIER. As Secretary Brady said yesterday, I do not think we think that repeals are a viable option at this time, but——

Chairman ROSTENKOWSKI. I am sorry. You think that it is a viable——

Mr. TRIER. We do not think it is a viable option at this time. There are the reasons you articulated in your opening statement when the bill was introduced. There are, at some level at least, important policy considerations that underlie section 89.

We think that the statute in its current form, really through no particular fault of anybody, does not work, but we are really in favor of replacing it with a substantially different piece of legislation.

Chairman ROSTENKOWSKI. Mr. Levin will inquire.

Mr. LEVIN. Let me ask you about your testimony on page 6 regarding the core health benefits. As I understand it, those benefits that are not considered core health benefits—you refer to dental and vision—are still included when the antidiscrimination provision is applied. Right?

Mr. TRIER. They are included when you apply the 133⅓-percent test.

Mr. LEVIN. In view of the fact that the concept of core benefits might change, why include, say, dental and vision statutorily?

Mr. TRIER. Or excluded statutorily.

Mr. LEVIN. Or exclude them, right.

Mr. **Trier**. Well, I think the answer to that is that that is one of the few cases which we really think are not appropriately viewed as core health benefits, and rather than have there be some confusion over it, have it be up to us to describe what are core health benefits. We think that would not be correct, and we also think it just simply should not be a way that you are satisfying the first test.

At the same time, as you know from the testimony, we do think that outside of that sort of far edge, we think that there ought to be significant flexibility on the part of the employer in determining what is really the core health benefits, and I think the test will accommodate that kind of flexibility.

Mr. **Levin**. One other question. Tell me, if you would conceptionally, how it is consistent to place limitations on the per week contribution of employees, but have no control or regulations that relate to deductibles?

Mr. **Trier**. I am not absolutely sure I have a well formulated response, but to just fill out what I think you are saying, is that is a cost, in a sense, to the——

Mr. **Levin**. Yes.

Mr. **Trier**. Yes. I think the difference between the deductible and the premium payments are that really to buy into the health insurance system at all, the employee is required to make the premium payment for his share, and if that is too high, he is going to be out of luck.

The deductible, on the other hand, if he has participated—you know, by paying the premium—the deductible admittedly is going to be a cost of his, but it is going to be something that is in the context of receiving presumably the insurance at the same time as the deductible, and I believe it really represents a somewhat different situation, but I would like actually to think about your point a little further.

Mr. **Levin**. OK. One last question. How adequate is the database about health coverage among small businesses? I think there is a concern throughout this committee about the impact of the bill. That is true of any legislation, but—and maybe I did not hear all of your answer on the question. Maybe this came up while I was gone to vote, but is there an adequate database? Do we really know what is going on in terms of health coverage with small businesses that would give us some basis for differentiation?

Mr. **Trier**. The first response—there is really two questions there. The first response is that, in candor, I am told on a daily basis that our data base for all health coverage is not what one would hope it is, and we have been really working on it since before the 1986 act, but it is the general problem that we have in considering all of these questions.

We know a lot more now than we did before section 89 was passed, but we do not know enough about any of it, and that impacts on us a lot.

As to the, you know, the basic special treatment of small businesses, I think that, although we do not have enough data to, for example, answer the question whether there is abuse out there 5 percent of the time, 20 percent of the time, or 30 percent of the time, we have learned a lot more.

We have worked with SBA people, and we do understand some things which are reflected in our testimony. That is, that the cost of insurance is larger for small groups of employees, that there are more likely to be individually rated. We have with small business groups to find that out, and in that respect, we feel somewhat confident that we can accommodate them in specific ways that achieves our goals.

Mr. LEVIN. Thank you. My colleagues are voting. I went over early, and there were a few more, I believe, who wish to ask you questions, and we are also waiting for the next witness who went over to vote. Do you want to say anything else? [Laughter.]

Mr. TRIER. You know, I am always put in the filibustering position. This is not the first time this has happened to me——

Mr. LEVIN. It is not?

Mr. TRIER [continuing]. And despite the fact that I am notoriously loquacious, I think I will not——

Mr. LEVIN. All right. I think what we will do is to recess briefly, but we will not keep you very, very long.

Mr. TRIER. OK.

Mr. LEVIN. We like members of the executive to go back to the office——

Mr. TRIER. And write regulations.

Mr. LEVIN. Well, maybe not. [Laughter.]

But anyway, we will just take a brief recess, and if someone on the list who has not asked questions yet returns soon, we will continue. If not, we will go on to the next witness. So we will be in suspense here for 5 minutes.

Mr. TRIER. Okey-doke.

[Brief recess.]

Mr. LEVIN [presiding]. We are going to reconvene, and with our expression of appreciation, Mr. Trier, you are excused.

Mr. TRIER. Good. [Laughter.]

Mr. LEVIN. Thank you. As you know, Mr. Trier, there may be some further questions. You have already been asked some for submittal for the record. My guess is there will be many more.

Mr. TRIER. Thank you.

[Treasury was unresponsive to the following congressional inquiries:]

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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

May 23, 1989

The Honorable Nicholas F. Brady
Secretary of the Treasury
U.S. Department of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

At our recent hearings on H.R. 1864, a bill to simplify the nondiscrimination rules applicable to employee benefit plans under Section 89 of the Internal Revenue Code, a couple of the Members of the Committee did not have an opportunity to ask your Tax Legislative Counsel, Dana Trier, some questions when he appeared on May 2, 1989.

I would appreciate it if you would have Mr. Trier reply to the enclosed question from Representative Kennelly. I am also forwarding a letter from Representative Anthony with a question for you. I would like to have a response to these questions by Wednesday, June 7, 1989. Please submit your responses directly to my office, to the attention of Diane Kirkland.

Thank you for your immediate attention to this matter.

Sincerely,

Dan Rostenkowski
Dan Rostenkowski
Chairman

DR:dk

Enclosures

Mrs Kennelly

Section 89 Hearing Questions

For Treasury

Mr. Trier, my State of Connecticut has asked whether they need to count prison inmates and patients in state facilities for the mentally retarded for purposes of Section 89. In the preamble to the Section 89 regulations, the Secretary specifically asked for comments in this area. Since the State of Connecticut does provide access to health care for both these types of individuals on-site, would Treasury support an exemption for these classes of individuals perhaps like that for college students included in TAMRA?

BERYL ANTHONY, JR.
4TH DISTRICT, ARKANSAS

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May 11, 1989

The Honorable Nicholas Brady
Secretary of the Treasury
1500 Pennsylvania Ave., N.W.
Room 3419
Washington, D.C. 20220

Dear Mr. Secretary:

During the recent hearings on H.R. 1864 before the Committee on Ways and Means, I indicated that I wanted to obtain Treasury's position on the use of cafeteria plans and flexible spending arrangements as vehicles to deliver health insurance to employees.

The following example illustrates my concern with regard to the way cafeteria plans and flexible spending arrangements are treated by H.R. 1864. Assume under an employer's cafeteria plan, single employees receive an employer contribution of $1,100. An employee electing no coverage can receive $820 in cash, leaving $280 as a noncashable benefit.

There are three "core" medical options:

Option	Cost
Low	$ 870
Middle	1,070
High	1,320

Thus, single employees can elect the middle option, using employer contributions. However, under the provisions of H.R. 1864, only $280 (the noncashable benefit) is considered as an employer contribution. As a result, employees are treated as paying $790 for the middle option coverage, even though the employer provides $1,100 for the employee to purchase coverage.

Since the amount deemed to be contributed by the employee ($790) exceeds H.R. 1864's $10 per week limitation on employee contributions, the coverage is considered unaffordable. This could result in highly compensated employees being taxed on all their benefits. My one question is: From a tax policy standpoint, is this a proper result?

Your attention to my request is greatly appreciated.

Sincerely,

Beryl Anthony, Jr.

Beryl Anthony, Jr.
Member of Congress

Mr. LEVIN. My colleagues are at various other undertakings at this time, and I think what we will do is go next to Mr. Frank Swain, who is Chief Counsel for Advocacy for SBA.

Mr. Swain, as you know from your previous appearances before committees, your entire statement will be entered into the record.

My colleagues raised a number of issues this morning. Their staffs are here, as well as anything you say being in the record. So we look with interest toward your testimony on some of the questions that were raised this morning. Please proceed.

STATEMENT OF FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY OF THE U.S. SMALL BUSINESS ADMINISTRATION

Mr. SWAIN. Mr. Chairman, thank you very much. I would prefer to have my statement received in the record, and simply summarize several of the points that we make in the statement, as well as attempt to comment on some of the questions and the dialog that committee members have had with Mr. Trier from the Treasury Department.

Our testimony basically makes three or four points. First, that it is increasingly important to small businesses to be able to provide health benefits for employees.

Second, that for circumstances far beyond their control, the cost of that coverage is increasing significantly. These include both medical and health insurance reasons as well as so-called external or regulatory reasons.

Third, and in particular, we think section 89 has had a major impact—is having a major impact on the propensity, of small employers, to provide health insurance coverage, and particularly the very small. Fourth, I would like to present some particular considerations raised by H.R. 1864.

My first point addresses a question that you asked Mr. Trier just a few minutes ago, is there extant data about what sorts of benefits are demanded by employees, and does that vary by firm size.

We have a good deal of data on firms that provide health insurance and the type of health insurance they provide. We are in the process of updating that data. Some of it has been included in our statement this morning, and we would be happy to provide the committee with further information.

After vacations, health insurance is the most frequently offered fringe benefit by employers, no matter how you slice up the world in terms of firm size. I dare say that, as the work force ages and grows more slowly, small employers will be forced by labor market conditions to become increasingly competitive in offering benefits of all types.

But clearly the primary fringe benefit of importance to employees is health care insurance. Specifically, most small businesses do now offer health care insurance, but that rate by which they offer health care insurance varies considerably by type and size of business.

We find that, to the extent employees are not covered by employers, it tends to be in the very small size class—10 or fewer employees—and within particular industries, especially the wholesale and retail industries, the low-wage service industries, and the construction industries. In effect, those industries that have the most imprecise and unpredictable cash-flow and have the most wide seasonal fluctuations also tend to be the industries with the lowest profit margins.

We firmly believe that because of demographic factors, where there is frequent labor force turnover—and because of cost factors. There is lack of coverage. Insurance is expensive and many small firms do not have a lot of profit. There is admittedly a lack of coverage in a number of very small firms.

This brings me to a very important point vis-a-vis section 89. Lack of coverage in small firms is not discrimination. Section 89 was enacted apparently to end discrimination, to end the phenomenon that, within a particular firm, a disproportionate level of tax benefits was going to some employees and not to other employees. Sometimes I see in support of this principle the assertion that small businesses do not have a lot of health insurance.

But those two points have nothing to do with each other. The fact is that if a small business does not offer health insurance, in all likelihood it does not offer health insurance to anyone at all. That is not discrimination. The absence of employer provision health insurance is not remedied by section 89, and in fact, I would propound that section 89 presently exacerbates this situation. An employer that does not offer any sort of health insurance at all will look to the cost of offering health insurance, particularly the cost imposed by compliance costs of section 89, and say, "It is just still too expensive."

The fact that many small firms do not have health insurance is a significant problem, but one not remedied by section 89 does not. In fact, it exacerbates the problem. I fully agree with Mr. Trier's statement in response to a question that he was asked—is there any evidence that there is significant discrimination within particular firms within small businesses? And the answer is, "No." Treasury has no evidence. The Small Business Administration has no evidence, and I am not aware that anyone has any evidence that discrimination exists, in particular, or disproportionately, within small firms.

Oddly enough, we think to the extent that there is data, it illustrates the opposite, as shown in the charts attached to our testimony. The fact is that when small businesses do cover their employees, they are more likely than larger firms to make all employees eligible.

The first chart indicates that 52 percent of firms in the very smaller sized categories, that have insurance make all employees in that firm eligible as opposed to considerably fewer firms in other sized categories.

Likewise, when asked the question—do you fully pay the insurance for employee? Again, those small firms that do have insurance have a better record than other sized firms. This illustrates my point that when they are good, they are very, very good, but when they are bad, section 89 makes it worse.

The point is, and Mr. Trier also mentioned it, that when small firms go into the insurance market, it is a very different market for larger firms. Many larger firms, of course, self-insure and can set their own parameters of coverage based on their own management decisions or their union negotiations.

Small firms are basically consumers in the market purchasing care from carriers often they have to include everybody in the business in order to fill out a large enough group to get any sort of competitive rate whatsoever. One of the problems, in fact, with section 89—we will get to in a minute—is the effect that lowering the threshold for part-time employees may have on the policy and on insurance rates for small groups.

Section 89 is not an aid to the many small firms and their employees who do not have insurance. There are some other tax and regulatory ideas that we have for that particular problem. It could be heard another day, I am sure.

But for the purposes of today's hearing, I think the current section 89 is making the situation from the perspective of small employers worse, and we think that that definitely needs to be turned around.

Let me now address our concerns, specifically with H.R. 1864. Basically, we believe its design-based approach is a positive step. As some of the previous questions pointed out, one size fits all creates an anomaly in many cases; however it also creates much needed simplicity. A small firm employer trying to purchase health insurance or benefits for his or her employees needs to know that their dollars are spent on the actual benefits and not on intermediaries and experts that are required to comply with complicated laws. So to the extent that we can make the laws simple, that is very good.

Second, and I think very importantly, it is an access test, rather than coverage test. Because of their employment patterns, many of their employees are part-time and seasonal workers. Many small firm workers also have other insurance coverage, sometimes with other employers, sometime with their spouse's employers.

The arithmetic necessitated by the current section 89, which is predicated on a coverage test, is simply too complex. So the one size fits all plan design and the accessibility standard, rather than the coverage standard, are two positive steps initiated in H.R. 1864.

Our two major suggestions for further consideration by the committee and the sponsors relate to the affordability standard and to the part-time standard.

The bill proposes a dollar amount as a test for affordability. We believe that a better approach would be to phase in an affordability standard, if there is to be one, in terms of a proportionate employer contribution. The dollar amounts will be outrun by inflation too rapidly and outrun by changing conditions between and among areas of the country and types of employers.

On the issue of part time, we certainly think it is a major step in the right direction to increase the standard from 17½ to 25 hours for accessibility by part-time workers. We would encourage the committee to raise that threshold to 30 hours or even higher.

The reason for our recommendation of a higher threshold is that we have heard consistently from small employers and from carriers that the industry standard for coverage of part-time workers is that they must work for at least 30 hours per week in order to be included in coverage.

Now this is not necessarily true in every industry, in every policy, and in every company, but it does, seem to be the general national standard. The reason is that when you start to cover part-time workers, insurance companies run into real adverse selection problems.

A 17½-hour worker may be the worker with severe health problems—that is, where Uncle Harry who has been waiting for the heart bypass slips onto the payroll and is suddenly covered under the insurance plan. The higher the threshold, I think the better risk arrangement there is for the carrier and certainly for the employer that purchases insurance.

I would also like to address some points that were raised in the questioning of Mr. Trier, and there is another set of options that the committee certainly should consider, and that is option of outright exemption. It seems to me that you look at exemptions in two ways. One is an exemption entirely from any section 89 provision for employers of less than a certain size—less than 10 employees, less than 20 employees, or whatever.

If the committee were to recommend a bill that exempted all employers from any section 89 standard of less than 10 employees, that would cover probably 10 million employers, but it would only cover about 10 percent of the work force. You would be saving a tremendous amount of administrative expense and consternation among the employers "giving up" a very slight level of protection for the American work force. Likewise, the committee should consider higher thresholds, even up to 20. I think the committee should give serious consideration to some sort of outright exemption. If not an exemption totally, then, as I was pleased to see the Treasury suggest for certain small employers, there might be an even more simple test based on a core benefit approach. This would, again, tend to minimize the administrative expense.

To summarize, Mr. Chairman, we think that H.R. 1864 is a major step in the right direction, but whether it is H.R. 1864 or another variation, it is absolutely essential to the small employers that the current section 89 be significantly changed. It is important for employers who are currently offering health insurance, and it is important if we are going to make any progress on our national goal, which I think everyone shares, of encouraging more employers to offer insurance.

Thank you very much.

[The statement of Mr. Swain follows:]

TESTIMONY OF HONORABLE FRANK S. SWAIN
CHIEF COUNSEL FOR ADVOCACY
U.S. SMALL BUSINESS ADMINISTRATION

Mr. Chairman and Members of the Committee on Ways and Means:

As Chief Counsel for Advocacy of the U.S. Small Business Administration, I am pleased to appear before you to discuss small business problems with Internal Revenue Code Section 89 and to offer suggestions for improving H.R. 1864, a recent proposal to simplify the law. Although Section 89 applies to many facets of the fringe benefit package, its impact on health benefits is our primary concern, and it is appropriate that the Committee has chosen to expeditiously review this law. Your Committee is to be commended for holding these hearings and for keeping the record open to suggestions for meaningful reform.

As you know, Section 89 was never intended to stimulate additional benefit coverage, either health care or life insurance; rather, Section 89 was meant to promote more equitable distribution of benefits, where the firm and its employees receive tax subsidies for the provision of those benefits. It is premised on the belief that the subsidy alone -- the exclusion of such benefits from employees' gross income -- will induce the highly compensated employees to compel the employer to extend benefits to all employees of the firm. Section 89 sets the parameters for treatment of employer sponsored fringe benefit plans to ensure that the substantial tax expenditure for excluding the value of health coverage from income, $36 billion, is efficiently used. It is this subsidy approach upon which the voluntary, employer-sponsored health benefit system is based.

Although few disagree with the concept behind these tax policy goals, businesses, large and small, have appropriately criticized the means to accomplish these goals, specifically the method adopted for testing equitable distribution. Section 89 is overly complex, costly to comply with and to administer, and will impose unnecessary burdens on an already stressed employer-sponsored health benefits system. For many small employers, the paperwork and compliance costs of Section 89, together with uncertainty of compliance, will outweigh the tax benefits of the underlying subsidy, and discourage, rather than encourage the provision of health benefits. The goals of Section 89 can be served only through simpler, alternative approaches, which will ensure benefits are equitably distributed without overly burdensome administrative and compliance costs.

I believe that meaningful legislative reform of Section 89 must:

- Dispense with the complex testing arrangements and alternative minimum participation test in current law and adopt a design-based approach.
- Eliminate the requirement that employees actually participate in the health plan in favor of a requirement that the firm make the plan available to a certain proportion of its employees.
- Reduce data requirements, paperwork and compliance burdens.
- Adopt in the statute a costing method for determining value.
- Raise the threshold for part-time workers.
- Eliminate any set dollar amount thresholds in favor of simpler percentage tests which directly reflect changes in health care costs.

H.R. 1864 advances reform of present nondiscrimination rules. Two alternatives that might be considered, however: (1) replacing the dollar amount for maximum employee contributions with a percentage of minimum employer contributions designed in a way to assure affordability; and, (2) developing transitional rules to phase-in the coverage of part-time workers and the minimum employer percentage contribution.

I. Employer-Provided Health Benefits in Small Firms

I would like to direct my remarks here today to the effect of current law and the recently introduced legislative proposal on small business health benefits. Health care coverage and maintenance of the voluntary, employer provided health benefit system is of great concern to this Administration. Before discussing the relative merits of H.R. 1864, however, I would like to dispel a common misconception that has fueled much of the debate on Section 89: that small employers tend to discriminate in the provision of health benefits.

While it is true that about three-quarters of the working uninsured and their dependents are found in small firms, our studies show that small firms with health benefits more frequently offer coverage to all their employees than do large firms. About 44 percent of small firms with fewer than 100 employees versus less than 25 percent of large firms (more than 100 employees) indicate that all employees are eligible for health insurance coverage[1] (Chart 1). Small firms that do not extend health care to their employees, on the other hand, fail to do so because they can not afford the high insurance cost. Variable or lower profitability make it difficult to incur these costs.[2]

Part-time and seasonal workers in small firms are also more likely to have the opportunity for coverage. In large firms, 76 percent of part-time workers[3] and 59 percent of seasonal and temporary workers[4] are excluded from health coverage compared with 68 percent and 49 percent, respectively, in small firms. Furthermore, part-time and seasonal workers are more likely to be found in small firms. Part-time employees working less than 35 hours comprise almost 30 percent of the small firm workforce compared with about 16 percent in large firms.[5] Largely as a result of the higher proportion of part-time workers, labor turnover is also much higher in small firms. About 27 percent of workers in small firms move every year compared with 15 percent in large firms.[6]

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[1] ICF Incorporated, Health Care Coverage and Costs in Small and Large Businesses (Washington, D.C.: prepared for the U.S. Small Business Administration, Office of Advocacy, Under Award No. SBA-9267-AER-85, April 15, 1987), p. III-18.

[2] ICF Incorporated, op. cit., pp. III-11, III-15 to III-16.

[3] Ibid., p. III-16.

[4] Ibid., p. III-16.

[5] The State of Small Business: A Report of the President (Washington, D.C.: U.S. Government Printing Office, 1986), p. 245.

[6] Berkeley Planning Associates, Labor Turnover and Worker Mobility in Small and Large Firms (Washington, D.C.: prepared for the U.S. Small Business Administration, Office of Advocacy, under Award No. SBA-2092-AER-87, December 1988), p. 3.6.

The Committee should also recognize that when small firms extend benefits to their employees, they also tend to pay a larger share of the premiums. About 52 percent of small firm workers in firms with fewer than 100 employees versus less than 43 percent of large firm (more than 100 employees) workers indicate they pay nothing for health insurance (Chart 2).

Premiums are also costlier for employers in small firms. Small firm employers pay average monthly premiums about 10 percent higher for single coverage than large firm employers -- $87 compared with $80. For family coverage the premiums are over 20 percent higher -- $183 compared with $152 (Chart 3).

II. Present Law Adversely Affects Small Business

Health benefits are very important for small employers. The costs of benefit packages are increasing at a time when the growth rate of the workforce is decreasing. These benefit packages are particularly important for attracting and retaining workers. After paid vacations, health insurance is the most common fringe benefit offered by firms. Of the nonagricultural, private wage and salary workers, 50 million employees, or 62.5 percent, have direct employer-provided health plans. Firms of less than 100 employees cover approximately 15 million workers in this category.

Tax policy changes in 1986 attempted to more closely connect the receipt of tax subsidies for health benefits for highly compensated employees with that of the larger workforce. However, the approach used in the Tax Reform Act premised fairness in actual receipt of benefits by non-highly compensated employees at the distribution point, rather than simply assuring nondiscriminatory availability. By relying on receipt for the nondiscrimination test, employee choice became a controlling factor for small employers, and made it possible for small groups to be in compliance one day, and out of compliance the next, without changing their plans. For small business, where 14 percent of employees who are offered health benefits decline coverage, workforce changes and employee choices can greatly affect a firm's ability to meet the nondiscrimination requirements.

Small employers are disadvantaged by the imposition of complex and costly compliance measures added to spiraling health care costs. Small employers who are faced with an exceedingly difficult legal maze, and a volatile health insurance market will limit their exposure to such a market by restricting or withdrawing employer sponsored coverage.

Furthermore, present law significantly disrupts small employer relationships with traditional providers of insurance information, i.e. insurance agents. Small employers rely upon these sources of information since they do not usually utilize employee benefit experts. Though such cost is deductible, so is the cost of employer-provided premiums. For employers for whom health insurance is marginally affordable, deductible premiums would be displaced by deductible plan services, thereby reducing actual health care spending for employees.

Our knowledge of health benefits among small firms leads us to conclude that affordability and access is key to the formation of small business health insurance plans, and that the necessity of delivering a broad group to the insurance carrier in order to receive or continue coverage controls how small business offers health benefits. The failure to offer any health plan whatsoever does not reflect discriminatory practices, but the failure of the underlying tax incentives to adequately stimulate the provision of health care. Section 89, in its present form, will impose additional costs at a time when small firms need it least.

III. Considerations for Reform

The costs of compliance with current Section 89 are disproportionately imposed on small employers who already experience health costs of between 10 to 40 percent higher than large employers -- discouraging, rather than encouraging the provision of health benefits. The steps toward simplification as drafted by this Committee are indeed valuable, especially the restructuring of nondiscrimination rules to address availability rather than actual receipt. Such restructuring dramatically decreases the data and recordkeeping requirements.

There are other problems endemic to the small business market that affect the higher premium rates. The fact that small business has higher per capita premium costs, higher employee turnover rates and greater use of part-time employees also increases administrative costs for small firms relative to large firms.

Small firms are much less likely to self-insure, which means that their policies must reflect both the limitations of size and the cost of state-mandated health benefits in their insurance policies. They are far less likely to be able to effectively control their costs as large firms by negotiation or by self-insuring.

The small employer market also seems to pay a substantially larger contribution for single employee coverage and much smaller for dependent coverage. Small employers are more likely to hire young single workers. In fact, two-thirds of all entry level workers are hired by small firms, and 66 percent of all workers ages 16 to 24 are employed by small firms. The Committee should recognize these essential components of health insurance premium costs as they consider H.R. 1864.

IV. H.R. 1864 -- Further Change Necessary for Small Business

H.R. 1864 would succeed in addressing several important policy concerns of small employers, while furthering the essential purposes of existing law. Most notably, the proposal would greatly reduce complexity, paperwork burdens and, ultimately, the costs of providing health care by small employers over current law. Yet, while the proposal represents a substantial improvement over current law, alternatives should be considered in at least two important areas: (1) achieving affordability through the establishment of minimum employer contributions determined on a percentage basis and (2) developing transitional rules to ensure a smooth phase-in of maximum contribution amounts and for the part-timers threshold.

Among the improvements to Section 89, the bill would permit a firm to more easily determine compliance with the distributional requirements by adopting a design-based approach. This will allow firms to initially determine what changes must be made in the plan in order to comply with Section 89, and will allow insurance companies to develop products that match these parameters. The design approach will also dispense with the need for audit and testing throughout the year by permitting easier analysis. An attendant advantage would be reduction in the data collection requirements by requiring the firm to track only the highly compensated employees. A design-based approach will also eliminate needless roadblocks to compliance by supplanting the requirement of actual participation by a percentage of employees in a firm with a test based upon availability.

Second, the proposal would equate costs with the value of a plan and continue efforts to develop a more complex system for valuation. While current law and the regulations anticipate a valuation table based on actuary studies, there is greater authority and logic in permitting employers to use a costing system to determine value, particularly for small employers. However, value should equate with cost where the same services are available, i.e. HMO's. The purpose for emphasizing value rather than costs in Section 89 is to alleviate problems that could develop from differences in cost, but not value, in different geographical areas. Small employers, however, are generally located in one geographical area. Valuation will merely add another layer of needless complexity.

Third, the proposal would redefine "highly compensated employee" (HCE) by establishing a more easily understood salary baseline. The identification of HCEs is fundamental for purposes of determining if a firm "discriminates" in their favor. The current law's three-tiered approach for purposes of determining who is a HCE added greatly to the expense of running the test and to the uncertainty of a firms's compliance with Section 89 when the status of HCE's changed.

Finally, the proposal makes needed advances to the issue of affordability by raising the threshold level of part-time workers that must be offered benefits. The question concerning the appropriate limits of coverage to part-time employees is often couched as a philosophical debate on the extent of employer responsibility. Far more than just a philosophical question, the extension of benefits to part-time workers raises real problems of adverse selection and affordability of the plan to all workers. Insurance companies know that part-time workers are generally greater health risks, and either do not permit them to participate in group health plans or raise rates accordingly.

The proposal, however, raises significant issues. To stimulate affordability, the proposal sets a maximum employee contribution by a set dollar amount. This contribution would be indexed to the social security wage base. The theory is that as medical expenses escalate, the maximum required employee contribution will increase. However, increases in health care costs bear no connection to this index, and could cause considerable noncompliance as health inflation rates escalates beyond the index.

In addition, the test does not take into consideration changes in health care costs for geographical locations. For small employers, who are all rated by such factors as geographical location, this will cause a great deal of disparity nationwide. The dollar value approach will allow the subsidy to be applied disproportionately across firm sizes. Furthermore, because small firms experience health care cost of between 10 to 40 percent higher than do larger employers a constant threshold for all firms will permit larger companies, with lower health care costs, to contribute a smaller share to their employees plan. Finally, indexing will add another layer of complexity for compliance and administration.

An alternative approach would be to use a percentage of employer contribution to the employees' health care premium costs. No indexing will then be needed, but the required employer contribution will increase with actual employer health care costs consistent with affordability.

Another essential improvement is to raise the part-time exception. We have heard from employers around the country that insurance companies do not insure employees who work fewer than

30 hours. New Hampshire has the only state law requiring insurers to make insurance available to employers for workers below 30 hours. Insurance companies assume that part-time workers who elect coverage are an adverse selection problem. We must note, however, that maintaining the limit at 25 hours presumes employment practices and insurance company practices will be altered to apply below the 30 hours range.

Conclusion

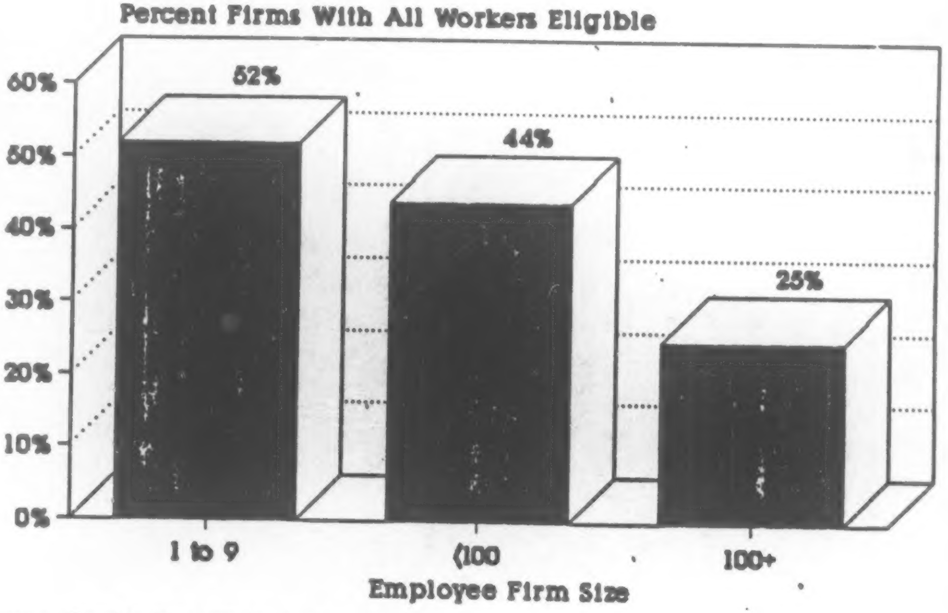
We are concerned that the dollar limitations for employee contributions might build in to the legislative proposal a level of inflexibility to the year-to-year changes in insurance premiums, as well as the geographical differences in health insurance premiums. A percentage of cost approach may also alleviate the need for indexing. Premium costs will track the rise in health care inflation, and take into consideration the fluctuation in the market due to geographical location which so greatly affect small employers.

As noted previously, we believe consideration should be given to a transition rule so that the market will not be unduly jolted by changes to the law.

Future innovative efforts in plan design will be affected by rising health care costs, the need to carefully manage these costs, and new government regulations such as Section 89.

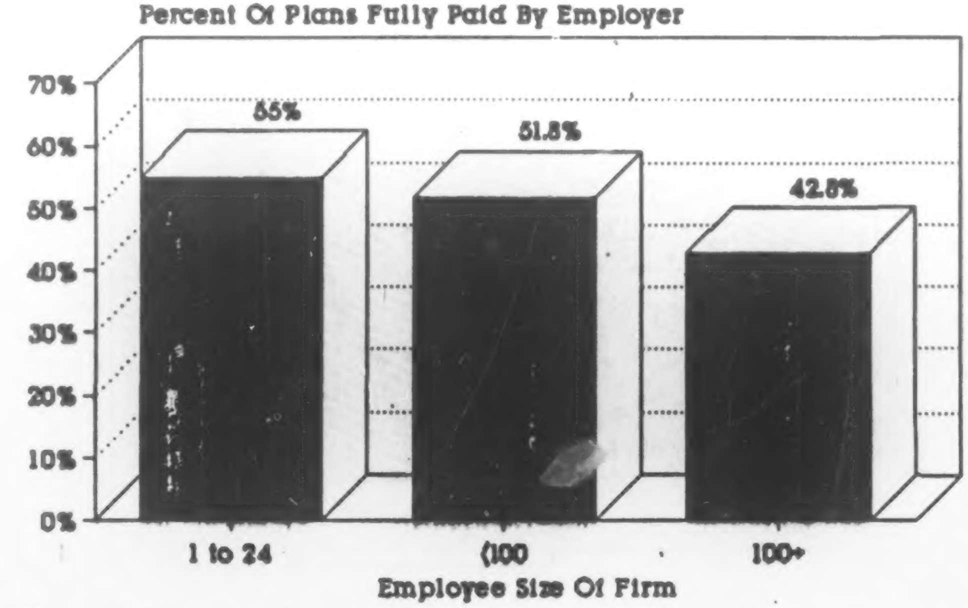
This concludes my prepared remarks. I would be pleased to respond to your questions.

Employee Eligibility For Health Insurance By Firm Size

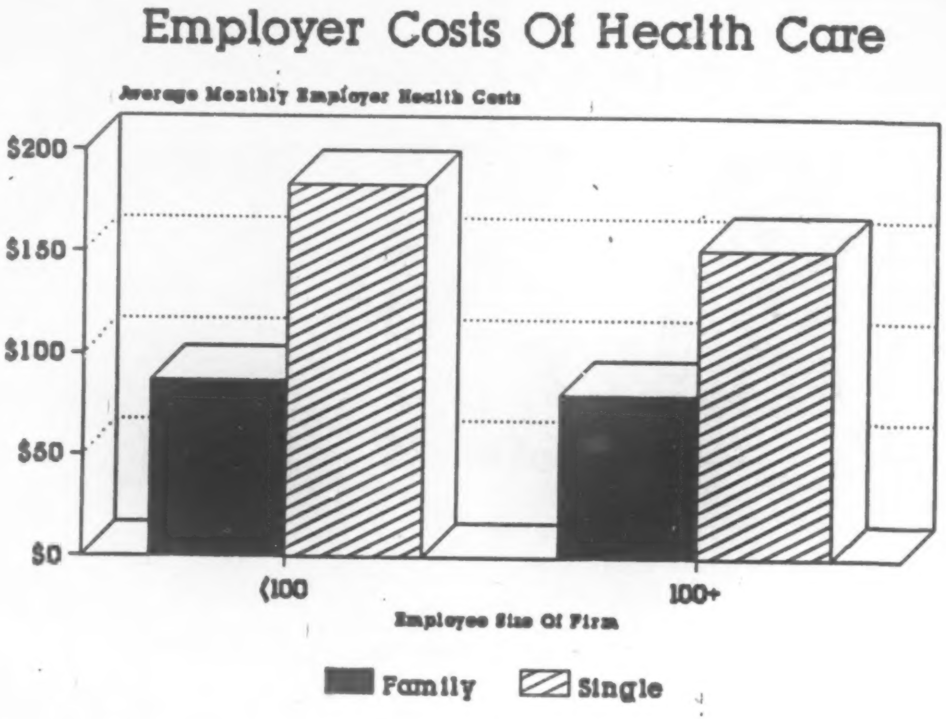


Source: Health Benefits Data Base, 1986

Proportion Of Employee Health Plans Fully Paid By Employer



Source: 1987 President's Report



Employer Costs Of Health Care

Source: SBA, Health Benefits Data Base, 1986 (inflated to 1988 using CPI medical care).

Mr. **Levin.** Thank you. Mr. Guarini will inquire.

Mr. **Guarini.** Thank you. Mr. Swain, currently there are—half of the people who are employees that are not covered by health insurance are small businesses that you speak for. Is that correct?

About 37 million Americans that are not now covered by health insurance, half of them are small business people by the definition of small business?

Mr. **Swain.** My understanding of those statistics is a little bit different—not too much. Of the 37 million people that do not have health insurance, there are about 24 million or about two-thirds of them that are either employed or dependents of an employee.

It is important to realize of that 37 million that do not have health insurance, there is fully one-third that are totally unemployed and would not receive any sort of coverage under an employer nexus arrangement, such as section 89 is trying to perfect, or mandated benefits for that matter.

Of the two-thirds of 24 million who have some connection to the work force, about two-thirds of those or 16 million either work for small firms or are dependents of people that work for small firms.

There is a significant number of people with no health insurance who work for larger companies, but they tend to be part-time workers. People who work for small companies that do not have insurance are more likely to be full-time workers that are not covered at all, and their employer has no coverage for anyone.

Mr. **Guarini.** Right. Now your position is that section 89 should absolutely be repealed, which seems to have a very strong support in Congress, but couldn't there be a consensus between what is in the LaFalce bill and what is in the committee's bill by the chairman?

Mr. **Swain.** Well, I think our position for purposes of this hearing this morning, Mr. Guarini, is that if there is to be in the tax law some sort of attempt to discourage discrimination, that the chairman's bill, H.R. 1864, is a much more effective, less problem-laden approach than current section 89.

Mr. **Guarini.** How would you treat regional differences where wage and health cost have such a big disparity between different sections of our country? I think that is a growing concern and even in other areas, including wages for different kinds of Government employees. I know it is starting to happen with the FBI, et cetera.

Now, in terms of benefits and tax policy advantages where we know that there are lower salaries in some areas and lower health costs, et cetera, how would you treat regions, if there is a big disparity in your mind?

Mr. **Swain.** Well, I think, and I absolutely agree with your question, that part of the major problems in the current law is that the handling of regional disparities, especially for a larger company with many operations in various regions throughout the country, is very difficult.

I think H.R. 1864 handles many of those issues by going to a simplified design based approach. That is why we are making the suggestion this morning the amount should be expressed as a percentage rather than deem a plan affordable, if the employees are required to put in no more than *x* amount for single and *x* amount for dependent coverage.

The dollar amount may be perfectly rational in Omaha, but totally irrational in New Jersey. It should be expressed in terms of a percentage test by employer, and that way, you take the entire cost of the plan in Omaha and the percentage that the employer contributed would bear certain relation to it and pass the test.

Mr. GUARINI. So you think there should be some type of differential instead of using the flat sum of money that would apply to everybody as the people from the lower income areas may be paying a higher percentage of the national costs?

Would you write into the bill a differentiation regionally?

Mr. SWAIN. No, I do not think I would write—from our perspective we would not write regional differentiations into this bill. We would write into the bill a percentage so that, from a small business perspective, when a small business owner has a plan that cost different amounts in different sections of the country, the percentages would be different based on the cost of that plan.

You never would mention the word regional in the language of the statute. The proportionate test in terms of a percentage rather than a flat dollar amount would allow you to take into account those regional variations.

Mr. GUARINI. Well, since employee contributions under H.R. 1864 are indexed to wage inflation, and since health care cost inflation is greater than wage inflation, won't employees have to pay a repressively greater share of the cost as health care inflation continues to increase?

Mr. SWAIN. Well, it seems to me—that is another problem that you—yes, I would agree that——

Mr. GUARINI. This could get to be a runaway situation where one has maybe a 3.5-percent inflation level in health care cost that are escalating tremendously, maybe 11 percent or better and still getting greater.

So, you can see it will not take very many before there will be a tremendous differential. How would you address that problem?

Mr. SWAIN. I will give you two alternate suggestions. If there is to be an indexing provision in the law, then the index should definitely be to health care inflation and not wage inflation or Social Security wage base.

If the issue is tax benefits or tax expenditures from purchases of health insurance, it should be connected to a Government-published index very specific to that particular cost. I am sure the committee has heard other testimony with which I fully agree that the inflation rate on health care cost far exceeds any other inflation rate.

So, if there is to be an index, I think it ought to be health care cost index. However, if the bill uses a proportionate contribution test, rather than flat dollar amount indexed upwards, the need for an index is eliminated because presumably the proportion will be the same no matter what the inflation is.

Mr. GUARINI. Thank you, Mr. Swain. My time is up, and I thank you for your advice.

Mr. SWAIN. Thank you.

Mr. LEVIN. On your chart, Mr. Swain, the first chart where it talks about the employee eligibility. Do you know whether those figures include part-time employees?

Mr. **Swain**. I believe they do, Mr. Levin. I will have to check the original survey instrument that I—I believe they include part-time employees.

Mr. **Levin**. You are not sure what the cutoff point is?

Mr. **Swain**. I would have to go back and check.

We asked a fairly straight forward series of questions. How many employees do you have? Do you have health insurance? How many employees do you cover under your health insurance?

The first chart reflects the fact that 51 or 55 percent said, "We cover all employees." I can go back and look at our basic data and come back to you with some very specific further data. I just do not have it with me this afternoon.

Mr. **Levin**. The survey data—it is a sampling procedure?

Mr. **Swain**. Yes, sir. It was a sample—it was a mail survey taken in 1987 by ICF Lewin & Associates of several thousand randomly selected business owners, and I believe it fits any norm of statistics as to its efficacy.

Mr. **Levin**. Let me suggest that you provide the committee the fullest possible data. I think there is a desire to reflect reality in the new bill, and I think it goes a considerable way towards doing that, and it will help, I think, if we know the facts. And we just do not choose up sides without reference to them.

Because you indicate that the smaller the business the more the coverage. If that includes part time, I think it would indicate that we need to be careful in our delineation.

So, do send that as soon as you can.

One other question that I had—if you had to pick out from H.R. 1864 and your intimate knowledge of small business, one provision that might be burdensome in terms of paperwork and what is related to it, with consulting experts. What do you think would be the most troublesome for a small business, if any?

Mr. **Swain**. Well, that is a good question. Of course, I am tempted to say the whole thing is troublesome to the extent that it is. This is a new standard. It is not like pension rules where we have a current topheavy standard and propose to change the standard.

This is a new standard. Health insurance is not heretofore tested for discrimination. So, to the extent that people were doing no paperwork before and now have to do a lot of paperwork—you will find a lot of business people say that is a burden, obviously.

Mr. **Levin**. But, when you say a lot of paperwork—within the bill you have a few formulas that business with 10, 15, 20 employees—if it is explained in clear English, which is always a question in forms. But if it is, what would be difficult to after the initial familiarization process?

Mr. **Swain**. I think that we have asked committee staff from time to time a few clarifying questions on how they intended to handle a certain—a few provisions of the bill, and I think that—but I would be happy to write to you and the committee with a list of various areas which we consider muddy and may as drafted result in more paperwork than is necessary.

Mr. **Levin**. But basically, the important thing is the design base test with the clearly defined corps benefits.

Mr. **Swain**. There was a discussion, as you recall, with Mr. Trier. The question was posed to him of how Treasury would define something here, and he said, in effect, we would rather not be in that business too much of defining what you mean in your legislation, and I guess I would echo that.

As clearly as you can write the bill—that is important.

Mr. LEVIN. All right, Mr. Guarini.

Mr. GUARINI. Yes, I have one more question.

Mr. Swain, let me ask you. You are representing small businesses. Many of them are unincorporated, I assume?

Mr. SWAIN. Yes, indeed.

Mr. GUARINI. Now, in corporations that they meet the qualifications and are approved of for section 89. The employer-paid health insurance premiums would be 100 percent and can be deducted, can be written off. Yet, if you are unincorporated you can only take off 25 percent of the premium cost, I understand?

Mr. SWAIN. That is correct.

Mr. GUARINI. Now, does this pose a disincentive to those who want increased coverage and does this put unincorporated businesses at a big disadvantage?

Mr. SWAIN. Well, it clearly puts unincorporated businesses at a disadvantage compared to incorporated businesses. The current law, which by the way expires at the end of this year, is that if I do business as Frank Swain Inc. and pay myself a salary, I can deduct 100 percent of that health care insurance premium which I purchased myself. But if I do business as a self-proprietorship and purchase the same health care benefits, I can only deduct 25 percent.

Clearly it is an anomaly and inequitable there. From my perspective there is no health care policy reason to have that disparity. There is no tax policy reason to have that disparity. There is clearly a revenue impact, though, and extending that 25 percent deductible to 100 percent—I believe revenue impact is in the range of $1.5 to $2 billion over 5 years.

So, in terms of policy it is a revenue issue. It is not a health care issue. It is not a tax issue.

Mr. GUARINI. But it is also a fairness issue, is it not?

Mr. SWAIN. Absolutely.

Mr. GUARINI. And one thing for compliance, we want people to understand that the internal revenue code is fair. Would you suggest a different percentage than 25 percent, or would the small business administration people be happy with 25 percent?

Mr. SWAIN. Well, first of all, I think your question hits the nail on the head.

When we take a look at the companies that do not have health insurance, they tend to be disproportionately self-proprietorships. So, I think the fact that the tax incentive is slight adds to the problem that we have in encouraging the very small businesses to purchase coverage.

I think certainly the small business community has taken the position that, it ought to be 100 percent deductible. We ought to all be on the same footing as self-proprietors and small corporations alike.

As a member of the executive branch, I am simply putting out the disclaimer that—and I am aware that there are revenue cost to that, but certainly as a matter of good small business policy that disparity ought to eliminated.

Mr. Guarini. So, that position is the position that you are taking, that they should be put on the same footing of 100 percent with regular corporations so long as they comply with section 89?

Mr. Swain. I certainly think that in the ideal world, they should. I am aware that the Treasury Department has testified that the revenue cost of that current deduction are such that they do not even recommend that it be extended next year at all.

Mr. Guarini. But you can always disagree with Treasury?

Mr. Swain. Well, we have made that point from time to time.

Mr. Guarini. Thank you, Mr. Swain.

Mr. Levin. Mr. Andrews.

Mr. Andrews. Well, a little bit earlier, Byron Dorgan suggested that he might have an amendment that would exempt small businesses from section 89. Give me your thoughts about that. I am sure that this is somewhat redundant, but also tell me, if you could, what would be an appropriate size to exempt?

Mr. Swain. Well, I think that—first of all realizing that my thoughts are mine personally, and I would agree with Mr. Trier that the administration has come to no formal position on this.

To the extent that they are mine personally, they are a little bit different than Mr. Trier's were, to the extent that I believe one option the committee should consider is to eliminate the coverage under section 89 of whatever nature of small firms.

In his testimony, Mr. Trier suggested that there might be a simplified test for businesses with 10 or fewer employees. That would be as many as 10 million employers, yet it would only be about 10 percent of the current employment in the United States because what you are really doing is eliminating from section 89 coverage a lot of businesses employing 1 or 2 workers.

If you raise the threshold and consider about 20 or under as a cutoff, that would eliminate from section 89 coverage about 18 percent of the work force or about 20 million workers.

It is a series of tradeoffs, obviously, as perhaps your question or others indicated earlier—Mr. Dorgan's question. There are different limits depending on the type of laws, but I certainly think that if the committee is interested in pursuing this approach, we will be happy to provide the data as to what level you choose, what the impact is on numbers of employees and numbers of employers that would be covered by such an exemption.

Mr. Andrews. I would be really receptive to that, and we would appreciate it and I know Mr. Dorgan would as well if you would devote some time to that and submit something to us to take a look at with more details.

Mr. Swain. Yes, sir.

Mr. Andrews. Thank you.

Thank you very much, Mr. Chairman.

Mr. Levin. Thank you very much, Mr. Swain.

Mr. Swain. Thank you.

Mr. Levin. We will now go to the first panel, Mr. Johnson, Mr. Klotz, Mr. Marshall, Mr. Hoffman, accompanied by Deborah Walker and Mr. Hansen.

[Pause.]

Mr. Levin. All right. I think each of you is familiar with the ground rules. So, proceed as you would like. The more you address the issues that have evolved so far, I think, the more helpful it is, and your statements will be automatically entered into the record.

Mr. Johnson.

STATEMENT OF CALVIN JOHNSON, LEGISLATIVE REPRESENTATIVE, DEPARTMENT OF LEGISLATION, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. Johnson. Thank you, Mr. Chairman.

I would like to say that I am accompanied this afternoon by Miss Karen Ignagni, who is associate director of the Department of Occupational Safety, Health and Social Security from the AFL-CIO.

The AFL-CIO is pleased to have this opportunity to comment on H.R. 1864, which will provide welcome relief from current antidiscrimination rules for employee benefit plans.

Organized labor has long supported the intent of the original section 89 provision to prevent employers from offering tax subsidized benefits to executives while providing little or no benefits to lower wage employees. Nonetheless, the complexity of the provision, it's burdensome record-keeping procedures and the delay on the part of the IRS at issuing regulatory guidelines, has created an administrative nightmare for labor and management benefit managers.

Section 89 also has proved to be a boon to private benefit consultants whose fees get passed on to beneficiaries in the form of higher cost for lower benefits.

We are pleased, therefore, to lend our support to your efforts to replace the current provision with the simple and fair antidiscrimination test designed to expose discriminatory practices without placing undue burdens on companies that are providing decent benefits. We applaud your efforts to streamline the testing process by allowing employers to look at the design of the benefit plan to determine whether it is in compliance with the committee's proposed requirements.

While we share your view that reasonable limitations on employee cost sharing will make it possible for working families to participate in benefit plans, we have strong reservations about whether the provision as currently drafted will accomplish this objective.

Accordingly, we would like to offer some suggestions for changes in seven areas, and if you do not mind, Mr. Chairman, I will simply summarize the areas that we go through.

One, the definition of core benefits; two, the permissible difference between the value of benefits provided to nonhighly and highly compensated employees; three, the hourly coverage threshold for the definition of excludable employees in the collective bargaining agreements; five, the treatment of multiemployer plans; six, employer penalties for noncompliance with qualification requirements; and seven, coverage of part-time workers.

As the committee is aware, insurance premiums for health care benefits are developed by projecting inflation, utilization, changes in a group's demographic composition, and new technological developments. Geographic location and size of firm also play important roles in determining the final premium price. Therefore, the cost of a specific package of benefits can vary widely from employer to employer around the country.

We would specifically propose that in looking at the cost to individuals that deductibles be limited to $250 per individuals and $500 for families. That coinsurance be limited to 20 percent, and that there would be an overall cap of $3,000 on total out-of-pocket expenses. The AFL–CIO recommends that such limits be added to the definition of core benefits that must be provided. Otherwise, implementation of the proposed provision could invite the type of benefit inequities that gave rise to the original section 89 provision.

The AFL–CIO would like to express our concern about the second part of the proposed legislation which limits the difference between the value of benefits provided to highly compensated employees to 133 percent of the value of benefits provided to nonhighly compensated employees.

In our view, this figure is much too high. For example, if $200 were the value of the premium for the nonhighly compensated employee, the premium for the highly compensated employees could not exceed $266. Looking at the health policy agenda data, four out of five employer groups modeled this $66 difference in premiums would allow the highly compensated employee to have additional benefits that could include a basic dental plan, wellness programs, baby care, physical and occupational therapy, skilled nursing home care, and home care.

We do not believe that Congress intends to incur such a dramatic difference in benefit availability. Therefore, we propose that you consider limiting the allowable difference in premium value between highly and nonhighly compensated groups to 120 percent.

As currently drafted, the legislation contains overly broad language that would exclude employees engaged in certain fields. We recommend, instead, the committee consider the following language, which limits the exclusion to specific professional employees who on any day of the plan year perform professional services for the employer as a certified or other public accountant, actuary, architect, attorney, chiropodist, chiropractor, executive investment banker, medical doctor, dentist, optometrist, osteopath, podiatrist, engineer, psychologist, stock broker, veterinarian, or in such other professional capacity as determined by the Secretary.

This language has also been proposed by the Department of Treasury to implement antidiscrimination provisions for pension benefits plans.

While we support your desire not to allow professional corporations through sham bargaining arrangements to take advantage of special provisions designed for legitimately collectively bargained plans, we are concerned about employees who fall into these categories and work as staff for nonprofit organizations or State and local governments.

We would be pleased to work with you staff to develop language that addresses this problem.

Another concern involves situations where there is a two-tiered benefit structure for part-time and full-time workers. As some industry's unions have been able to negotiate benefits for all part timers but they may not be equivalent to benefits provided to full-time workers, which may prevent the plan from meeting this section 89 test.

Therefore, we propose that the committee exempt from any penalties any highly compensated workers covered under a collective-bargaining agreement.

The committee has proposed that the hourly requirement for section 89 testing be raised from 17½ hours to 25 hours. Since 1980, the number of part-time workers has increased by 40 percent. Currently, 20 million individuals work part time. Fifty percent of those work 20 hours a week or more. We are concerned that unless employees who work more than 20 hours per week are included in the nondiscrimination test, more than one-half of them will continue to go without needed health care protection.

In our view, this is particularly inappropriate in the service industry where part-time employees are an integral part of the work force.

The AFL-CIO fully supports the committee's proposal to place a penalty on employers who do not comply with the qualification requirements in the legislation. We agree that the current provision is unfair because employees do not have control over the design of plans. Using the same rationale, the AFL-CIO proposes that all penalties under section 89 be placed on employers.

We also have some suggestions, Mr. Chairman, on multiemployer plans and annual adjustment to premiums which we would be happy to sit and discuss with the staff at a later date.

Thank you very much.

[The statement of Calvin Johnson follows:]

TESTIMONY BY CALVIN JOHNSON, LEGISLATIVE REPRESENTATIVE
DEPARTMENT OF LEGISLATION
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
ON SIMPLIFICATION ON SECTION 89 OF THE INTERNAL REVENUE CODE

May 2, 1989

The AFL-CIO is pleased to have this opportunity to comment on H. R. 1864, the Simplification of Section 89 of the Internal Revenue Code, which will provide welcomed relief from current antidiscrimination rules for employee benefit plans. Organized labor has long supported the intent of the original Section 89 provision to prevent employers from offering tax-subsidized benefits to executives, while providing little or no benefits to lower wage employees. Nonetheless, the complexity of the provision, its burdensome record-keeping procedures, and the delay on the part of the IRS in issuing regulatory guidelines has created an administrative nightmare for labor and management benefits managers. Section 89 also has proved to be a boon to private benefits consultants, whose fees get passed on to beneficiaries in the form of higher costs or lower benefits.

We are pleased, therefore, to lend our support to your efforts to replace the current provision with a simple and fair antidiscrimination test designed to expose discriminatory practices, without placing undue burdens on companies that are providing decent benefits. We applaud your efforts to streamline the testing process by allowing employers to look at the design of a benefit plan to determine whether it is in compliance with the Committee's proposed requirments.

While we share your view that reasonable limitations on employee cost-sharing will make it possible for working families to participate in benefits plans, we have strong reservations about whether the provision as currently drafted will accomplish this objective. Accordingly, we would like to offer suggestions for changes in seven areas: 1) the definition of core benefits; 2) the permissible difference between the value of benefits provided to non-highly and highly compensated employees; 3) the hourly coverage threshold; 4) the definition of excludable employees under collective bargaining agreements; 5) treatment of multi-employer plans; 6) employer penalties for non-compliance with qualification requirements and 7) coverage of part-time workers.

Expanding the Definition of Core Benefits

As the committee is aware, insurance premiums for health care benefits are developed by projecting inflation, utilization, changes in a group's demographic composition and new technological developments. Geographic location and size of firm also play important roles in determining the final premium price. Therefore, the cost of a specific package of benefits can vary widely, from employer to employer around the country.

A recent report, Health Policy Agenda for the American People (HPA) reinforces this point. In that study, actuaries estimated the cost of a basic benefit package of inpatient and outpatient hospital care, physician services, X-ray and laboratory procedures, and limited mental health care services to range from $1,300 to $2,800 per employee per year. These figures are composite rates based on a projected mix of single employees and families in one of five prototype groups located in various parts of the country.

The AFL-CIO is concerned that without exceeding the premium-sharing limitations in the bill, an employer located in a high cost area, in a small firm, in an uncompetitive market, or those that want to limit their health care contributions could pass on additional costs to employees in the form of higher deductibles and coinsurance. If the committee's objective is to make health care benefits more affordable so that working families can take advantage of plans offered through their employers, it should also place limits on other out-of-pocket payments, such as deductibles, copayments and stop-loss provisions. Specifically, we would propose that: 1) deductibles be limited to $250 for individuals and $500 for families; 2) coinsurance be limited to 20 percent; and 3) that there be an overall cap of $3,000 on total out-of-pocket expenses. The AFL-CIO recommends that such limits be added to the definition of core benefits that must be provided. Otherwise, implementation of the proposed provision could invite the type of benefit inequities that gave rise to the original Section 89 provision.

We urge you to consider reducing the level of premium sharing that would be permissible. A $25.00 per week premium for family coverage ($1200 annually) would amount to a disproportionate share of income for low wage workers. Many of our members who work as janitors, hospital orderlies, nurses aides, secretaries and retail clerks with average incomes of $12,000 could simply not afford to dedicate 10 percent of their take home pay to health care. Instead, we propose that the committee consider reducing the premium levels to $3.27 for individuals and $8.30 for families which were derived by taking 20 percent of the cost of a low option benefit plan. Another and perhaps more preferable alternative would be to limit employee premium-sharing to 20 percent with an overall cap on employee payments.

It should be noted that our proposed changes would by no means guarantee a so-called "cadillac" plan. In fact, the Wyatt Company's recently released 1988 group benefits survey shows that for basic health plans with major medical coverage, 76 percent require deductibles of $100 or less. A full 81 percent require premium sharing of less than $75 per month, with one-third in the sample requiring premium contributions of $25-$49 per month, and 32 percent requiring premium sharing of less than $25 per month. Similar information has been reported by the Department of Labor. In its 1986 survey of medium and largefirms employee premium sharing for individual and family coverage averaged $13 and $41 a month, respectively. Adjusting for inflation would produce current figures that are similar to those reported by Wyatt.

Narrowing the Permissable Difference in Value of Benefits provided to Highly and Non-Highly Compensated Employees

The AFL-CIO would like to express our concern about the second part of the proposed legislation, which limits the difference between the value of benefits provided to highly compensated employees to 133 percent of the value of benefits provided to non-highly compensated employees. In our view, this figure is much too high.

For example, if $200 were the value of the premium for the non-highly compensated employees, the premium for the highly compensated employees could not exceed $266. Turning again to the Health Policy Agenda data, for four out of the five employer groups modeled, this $66 difference in premiums would allow the highly compensated employees to have additional benefits that include a basic dental plan, wellness programs, well-baby care, physical and occupational therapy, skilled nursing home care and home care. Another study by Gail Jensen of the University of Illinois at Chicago and Michael Morrisey of the University of Alabama at Birmingham provides similar results.

We do not believe that Congress intends to encourage such a dramatic difference in benefit availability. Therefore, we propose that you consider limiting the allowable difference in premium value between the highly and non-highly compensated groups to 120 percent.

Provisions relating to collective bargaining agreements

As currently drafted, the legislation contains overly broad language that would exclude employees engaged in certain "fields". We would recommend instead that the committee consider the following language, which limits the exclusion to specific professional employees who on any day of the plan year perform professional services for the employer as a certified or other public accountant, actuary, architect, attorney, chiropodist, chiropractor, executive investment banker, medical doctor, dentist, optometrist, osteopath, podiatrist, engineer, psychologist, stockbroker, veterinarian or in such other professional capacity determined by the Secretary. This language also has been proposed by the Department of Treasury to implement antidiscrimination provisions for pension benefit plans.

While we support your desire not to allow professional corporations through sham bargaining arrangements to take advantage of special provisions designed for legitimate collectively bargained plans, we are concerned about employees who fall into these categories and work as staff for non-profit organizations or state and local government. We would be pleased to work with your staff to develop language that addresses this problem.

Another issue of concern to the AFL-CIO involves situations where there is a two tiered benefits structure for part-time and full-time workers. In some industries unions have been able to negotiate benefits for all part-timers, but they may not be equivalent to benefits provided to full-time workers, which may prevent the plan from meeting the Section 89 test. Therefore, the AFL-CIO would propose that the committee exempt from any penalties any highly compensated workers covered under collective bargaining agreements.

Coverage of part-time workers

The committee has proposed that the hourly requirement for Section 89 testing be raised from 17.5 hours to 25 hours. Since 1980 the number of part-time workers has increased by 40 percent. Currently, 20 million individuals work part-time, 50 percent of those work more 20 hours or more per week. We are concerned that unless employees who work more than 20 hours per week are included in the nondiscrimination tests, more than one-half of them will continue to go without needed health care protection. In our view, this is particularly inappropriate in the service industry where part-time employees are an integral part of the work force.

Employer penalty for non-compliance with qualification requirements

The AFL-CIO fully supports the committee's proposal to place a penalty on employers who do not comply with the qualification requirements in the legislation. We agree that the current provision is unfair because employees do not have control over the design of plans. Using the same rationale, the AFL-CIO would propose that all the penalties under Section 89 be placed on employers.

Multi-Employer Plans

In our view, the proposed legislation would be a major improvement for multiemployer plans, particularly since it retains the concept of the employer contribution being equivalent to the benefit being provided. A special rule may be needed for industries where employer contributions for benefits are a percentage of pay, while the benefits are standard for all individuals in the bargaining unit. Also, monthly or similar equivalents will be needed to correspond to weekly hourly requirements. Again, we are prepared to work with your staff to address the special needs of multi-employer plans.

Annual Adjustment in Premiums

The committee bill contains a provision to update the premium limits using the SSA wage data. Instead, we would propose using the Bureau of Labor Statistic's Average Weekly Earnings Index. This index reflects the earnings of production and non-supervisory workers and will insure that premiums increase at a pace which is commensurate with what lower wage workers can afford. Similarly, we would strongly oppose efforts to use the medical care component of the CPI for this purpose.

We hope that these suggestions are useful to the committee. We look forward to working with you and your staff to resolve these important issues.

Mr. LEVIN. Thank you very much.

Mr. Klotz. And you are accompanied by Mr. Mueller and Mr. Vine? You are going to testify separately?

Mr. KLOTZ. Yes, sir.

Mr. LEVIN. Then why do you not go first?

Mr. KLOTZ. OK.

STATEMENT OF H. RICHARD KLOTZ, CORPORATE VICE PRESIDENT AND DIRECTOR OF TAXES, MOTOROLA, INC., ALSO ON BEHALF OF THE ERISA INDUSTRY COMMITTEE AND THE SECTION 89 COALITION, ACCOMPANIED BY BRUCE A. MUELLER, CORPORATE DIRECTOR OF BENEFITS, AND JOHN M. VINE, COVINGTON & BURLING

Mr. KLOTZ. Thank you, Mr. Levin, members of the committee. My name is Richard Klotz. I am corporate vice president and director of taxes for Motorola, Inc.

I appear today on behalf of the ERISA Industry Committee and the Section 89 Coalition. I am accompanied by Bruce Mueller on my right and by John Vine of Covington & Burling, counsel to the ERISA committee.

The ERISA Industry Committee, commonly known as ERIC, is an association of more than 120 of the Nation's largest employers. ERIC's members provide broad-based employee coverage under a wide variety of health and other benefit plans. More than 25 million Americans are covered by ERIC's members' health plans.

The Section 89 Coalition is a voluntary coalition that has banded together for over 2 years to communicate its concerns about section 89 to the Congress and to the administration. ERIC and the Section 89 Coalition have been in the forefront of the efforts to reform section 89 to make it both manageable and effective. We do not think that tax favored health benefits should be exempt from nondiscrimination rules.

We salute the chairman and other sponsors of H.R. 1864 for the major strides that have been made toward reforming section 89.

H.R. 1864 recognizes what many employers have been saying all along, that nondiscrimination rules can be effective without being overbearing, that equity does not necessarily require complexity.

We particularly favor certain features of the new proposed bill: One, the bill provides relief for all employers, regardless of their size and regardless of whether they are in the private sector or in the public sector. Two, by focusing on the availability of affordable health care coverage, rather than on actual coverage, the bill substantially reduces the data gathering burdens imposed by current law.

Three, by eliminating the "sworn statement" and family status rules of current law, the bill markedly simplifies plan administration and avoids unwarranted intrusions into employees' private lives.

Four, by returning to the prior law nondiscrimination rules for group-term life insurance plans, the bill recognizes that rules designed for health benefits do not work when they are extended to other benefits.

While we support the objectives of broad availability and nondiscrimination, we also think that H.R. 1864 raises a number of problems that require correction. Let me mention a few of our principal concerns.

First, while we strongly believe that employer-provided health coverage should be broadly available, we also believe that the bill's 90 percent availability standard is too high. We are concerned that when the 90 percent standard is combined with a number of the bill's other provisions, particularly its treatment of leased employees and its elimination of the separate testing rule, will make many employers miss the 90-percent standard. To compound the problem, if an employer fails to meet the 90-percent standard by as little as one-tenth of one percent, the full force of the bill's discrimination penalties will apply.

We urge that, at the very least, the 90-percent standard be reduced to 80 percent. An 80-percent test would strongly advance the objective of providing broadly available, affordable health care coverage.

Second, the bill indexes the maximum employee premiums to wage inflation. We strongly urge that the maximum premiums be indexed to increase in the cost of medical care, not to wages. Indexing on the basis of the medical component of the Consumer Price Index would preserve the allocation of health care costs between employers and employees that the bill envisions.

Third, the bill provides that leased employees do not have to be counted if the leasing company makes available affordable core health coverage. This provision does not go nearly far enough in addressing a very serious problem. The Treasury's proposed leasing regulations have completely failed to provide the specific definition that employers need. Consequently, in most cases, an employer cannot determine who its leased employees are. To make matters worse, the regulations also have gone beyond the intent of Congress to treat as leased employees many individuals who never were intended to be covered.

The bill should be revised to provide that leased employees will not be taken into account until plan years beginning at least 1 year after the Treasury publishes the final employee leasing regulations.

We also are concerned by the bill's treatment of flexible benefit plans. Flexible benefit plans allow individual employees to choose the benefits that best suit their individual needs. In an era of a changing workforce and the two-earner family, employers have found that giving employees a say over the benefits they receive is welcome by employees at all pay levels.

Employers also have found that flexible benefit plans are a key part of their efforts to combat the rising cost of health care. Nondiscrimination rules should not impede employers' battle against health care cost inflation.

Because the bill provides for testing on an availability basis, flexible benefit programs present especially difficult problems. We will be pleased to work with the committee to develop solutions to these problems.

We also are concerned that H.R. 1864 requires unnecessary and costly continuous testing of the coverage provided to every highly compensated employee in the work force. As it is currently written, the bill requires an employer to measure the coverage received by each highly paid employee throughout the year. We urge that the bill be revised to permit once-a-year testing of the coverage provided to highly compensated employees.

Finally, the bill delays the rules for former employees for one year. Although we welcome the 1-year delay, section 89 should not apply to former employees at all until Congress fashions appropriate rules for them. This critical issue should not be left to regulations.

Mr. Chairman, we thank you for giving us an opportunity to present our views to the committee. We will be happy to respond to any questions.

[The statement of H. Richard Klotz follows:]

STATEMENT OF H. RICHARD KLOTZ
CORPORATE VICE PRESIDENT AND DIRECTOR OF TAXES MOTOROLA, INC.
ON BAHALF OF THE ERISA INDUSTRY COMMITTEE AND THE SECTION 89 COALITION

Mr. Chairman and members of the Committee, my name is Richard Klotz. I am Corporate Vice President and Director of Taxes for Motorola, Inc. I appear today on behalf of The ERISA Industry Committee and The Section 89 Coalition. I am accompanied by Bruce A. Mueller, Motorola's Corporate Director of Benefits, and by John M. Vine, of Covington & Burling, Counsel to The ERISA Industry Committee.

The ERISA Industry Committee, commonly known as ERIC, is an association of more than 120 of the Nation's largest employers. ERIC's members provide broad-based employee coverage under a wide variety of health and other benefit plans. More than 25 million Americans are covered by ERIC's members' health plans.

The Section 89 Coalition is a voluntary coalition of both large and small employers, managed health care plans, insurers, and benefits consultants that have banded together for over two years to communicate their concerns about Section 89 to the Congress and the Administration.

For over two years, ERIC and The Section 89 Coalition have been in the forefront of the efforts to reform Section 89 to make it both manageable and effective. We do not think that tax-favored health benefits should be exempt from nondiscrimination rules.

We salute the Chairman and the other sponsors of H.R. 1864 for the major strides they have made toward reforming Section 89. H.R. 1864 recognizes what many employers have been saying all along: that nondiscrimination rules can be effective without being overbearing, that equity does not necessarily require complexity.

We particularly favor certain features of the bill:

1. The bill provides relief for all employers, regardless of their size and regardless of whether they are in the private sector or in the public sector.

2. By focusing on the availability of affordable health care coverage, rather than on actual coverage, the bill substantially reduces the data gathering burdens imposed by current law.

3. By eliminating the "sworn statement" and family status rules of current law, the bill markedly simplifies plan administration and avoids unwarranted intrusions into employees' private lives.

4. By returning to the prior law nondiscrimination rules for group-term life insurance plans, the bill recognizes that rules designed for health benefits do not work when they are extended to other benefits.

While we support the objectives of broad availability and nondiscrimination, we also think that H.R. 1864 raises a number of problems that require correction. Let me mention our principal concerns.

The 90 Percent Test. While we strongly believe that employer-provided health coverage should be broadly available, we also believe that the bill's 90 percent availability standard is too high. We are concerned that when the 90 percent standard is combined with a number of the bill's other provisions -- particularly its treatment of leased employees and its elimination of the separate testing rule -- many employers that offer broad-based health plans to their employees will not be able to meet the 90 percent standard. To compound the problem, if an employer fails to meet the 90 percent standard by as little as one tenth of one percent, the full force of the bill's discrimination penalties will apply.

We urge that, at the very least, the 90 percent standard be reduced to 80 percent. An 80 percent test would strongly advance the objective of providing broadly available, affordable health care coverage.

Indexing. The bill indexes the maximum employee premiums to wage inflation. We strongly urge that the maximum premiums be indexed to increases in the cost of medical care, not to wages. If the maximum premiums are indexed to wages, increases in the cost of medical care could drastically reduce the employees' share of the cost of an affordable health plan. By contrast, indexing on the basis of the medical component of the Consumer Price Index would preserve the allocation of health care costs between employers and employees that the bill envisions.

Leased Employees. The bill provides that leased employees do not have to be counted if the leasing company makes available affordable core health coverage. This provision does not go nearly far enough in addressing a very serious problem. The problem is that, in most cases, an employer cannot determine who its leased employees are. For example, under current law, it is impossible to determine whether a company's leased employees include the employees of its suppliers, the employees of a construction company that it hires to build a plant, or the employees of a commercial laundry that it uses to launder the uniforms worn by its own employees.

The Treasury's proposed leasing regulations have completely failed to provide the specific definition that employers need. To make matters worse, the regulations also have gone beyond the intent of Congress to treat as leased employees many individuals who never were intended to be covered. For example, under the regulations, the employees of the U.S. Postal Service in a small town can be treated as the leased employees of a large company with a headquarters located in the town.

We strongly urge that the bill be revised to provide that leased employees will not be taken into account until plan years that begin at least one year after the publication of the final employee leasing regulations. In addition, we will be pleased to continue to work with the Committee and the Administration to develop a specific and workable definition that is targeted at the abusive cases that were the objects of the leased employee provision.

Flexible Benefit Plans. We also are concerned by the bill's treatment of flexible benefit plans. Flexible benefit plans allow individual employees to choose the benefits that best suit their individual needs. In an era of a changing workforce and the two-earner family, employers have found that giving employees a say over the benefits they receive is welcomed by employees at all pay levels.

Employers also have found that flexible benefit plans are a key part of their efforts to combat the rising cost of health care. Nondiscrimination rules should not impede employers' battle against health care cost inflation.

Because the bill provides for testing on an availability basis, flexible benefit programs present especially difficult problems. We will be pleased to work with the Committee to develop solutions to these problems.

Once-a-Year Testing. We also are concerned that H.R. 1864 requires unnecessary and costly continuous testing of the coverage provided to every highly compensated employee in the work force. As it is currently written, the bill requires an employer to measure the coverage received by each highly paid employee throughout the year. We urge that the bill be revised to permit once-a-year testing of the coverage provided to highly compensated employees.

If the only changes in coverage during a year are attributable to changes in family status or to elections made during the plan's annual "open season," and if the plan satisfies the bill's nondiscriminatory provisions test, once-a-year testing will adequately measure the plan's benefits. Of course, when a new employee is hired, or when an existing employee terminates employment, the employee should be allowed to prove that the coverage that he actually received was less than the coverage that he is treated as receiving under once-a-year testing. In addition, if an employer takes action to amend its health plan to change the design of the plan in mid-year, it may be appropriate to require separate testing for the period before the change and for the period after the change.

Former Employees. The bill delays the rules for former employees for one year. Although we welcome the one-year delay, Section 89 should not apply to former employees at all until Congress fashions appropriate rules for them. Unlike current employees, former employees do not have regular contacts with their former employers. As a result, most employers do not have the information that will be required if the availability standards that apply to current employees also are applied to former employees.

This critical issue should not be left to regulations. We urge that former employees be excluded from testing altogether, pending the outcome of congressional study of the issue.

Part-Time Employees. The bill increases the cutoff figure that differentiates a part-time employee from a full-time employee from 17½ hours per week to 25 hours per week.

In our view, the 25-hour figure is far more appropriate than the current, unreasonably low figure of 17½ hours. However, in order to give employers a reasonable transition period to phase into the new law, the bill should be revised to provide that the cutoff figure is 30 hours for 1989, 27½ hours for 1990, and 25 hours for 1991 and subsequent years. The phase-in will give employers the time they need to modify their plans to conform to the new requirements.

Separate Lines of Business. The separate line of business and separate operating unit provisions were a critical component of the Tax Reform Act's new coverage and nondiscrimination requirements both for pension plans and for employee benefit plans covered by Section 89. In most instances, in order to rely on the separate line of business and separate operating unit provisions, an employer must either comply with Internal Revenue Service guidelines or obtain a ruling or determination letter from the Service. Although the separate line of business provisions became effective at the beginning of 1989, the Internal Revenue Service has yet to issue even proposed guidelines or regulations. The Service also refuses to issue rulings or determination letters on separate line of business and separate operating unit issues.

Because the separate line of business and separate operating unit provisions are an integral part of the new coverage and nondiscrimination rules, employers need immediate relief. They cannot be asked to wait any longer for the Internal Revenue Service to issue regulations or rulings.

The bill should be revised to provide that employers may rely on a reasonable good faith interpretation of the statute in identifying their separate lines of business and separate operating units. Reliance on a reasonable good faith interpretation should be permitted until plan years that begin at least one year after the Internal Revenue Service both issues final regulations and begins to issue rulings on separate line of business issues.

The bill also requires an employer with separate lines of business to adopt a single testing day for all of its separate lines of business. We urge that this rule be changed, so that each line of business and separate operating unit may adopt a testing day that is appropriate for its business and its workforce. A testing day that is appropriate for one line of business with one employment pattern might well be inappropriate for another line of business with a quite different employment pattern. As a result, unless the single testing day requirement is changed, an employer in multiple lines of business could be required by the bill to adopt a uniform testing day that, in some of its lines of business, causes the employer to violate the nondiscriminatory provisions requirement. See Prop. Treas. Reg. § 1.89(a)-1, Q&A-1(c)(1).

Separate Testing Rule. The bill eliminates the separate testing rule that now appears in Section 89(h)(5). Under the separate testing rule, if an employer chooses to provide health coverage to a group of employees who otherwise could be excluded from testing (for example, because they have not yet completed six months of service), the employer may apply the nondiscrimination requirements separately to the otherwise excludable employees (in this case, employees with less than six months of service).

The bill should be revised to preserve the separate testing rule. Elimination of the separate testing rule makes it significantly more difficult for an employer to satisfy the percentage availability test (90 percent under the bill) and affirmatively discourages an employer from making health coverage available to groups of excludable employees. It makes no sense for the nondiscrimination rules actually to discourage employers from providing health coverage to any employee who is otherwise excludable from Section 89 testing. If the eligible group of excludable employees satisfies the statute's nondiscrimination standards, the excludable employees should not be required to be taken into account in applying Section 89 to the employer's nonexcludable employees.

Union-Represented Employees. The bill requires separate testing of union-represented employees. Although this rule will be useful in many cases, it also will make it more difficult for many employers to satisfy the bill's nondiscrimination standards. A large percentage of an employer's nonhighly compensated workforce often consists of union-represented employees. If the union-represented employees are excluded from testing the employer's nonunion workforce, the employer will get no credit for the fact that it provides health benefits to many nonhighly compensated union-represented employees and will be required to satisfy the percentage availability test solely with respect to its non-union workforce. When combined with the bill's stringent 90 percent test, the bill's elimination of the separate testing rule, and the employee leasing provisions, the bill's treatment of union-represented employees will make it unnecessarily difficult for such an employer to satisfy the bill's availability requirement.

Accordingly, we urge that an employer be given the option to test its union-represented and nonrepresented employees on a combined basis. In order to prevent any possible abuse, the bill could provide that the employer's election would be revocable only with the consent of the Commissioner of Internal Revenue.

Accidental Death and Dismemberment and Business Travel Accident Coverage. The Internal Revenue Service's proposed regulations under Section 89 provide that accidental death and dismemberment ("AD&D") and business travel accident ("BTA") benefits are health benefits for purposes of Section 89. See Prop. Treas. Reg. § 1.89(a)-1, Q&A-1(f)(1)(ii). However, the nondiscrimination requirements of Section 89 do not make sense when applied to AD&D coverage. Unlike traditional health coverage, AD&D coverage is generally provided in proportion to compensation. In consequence, the cost of AD&D coverage is directly proportionate to pay. The bill should be revised to provide that as long as AD&D coverage is provided in proportion to pay, it will not be considered to be discriminatory. The bill also should make clear that BTA coverage is a de minimis fringe benefit that is excludable from gross income pursuant to Section 132(a)(4) of the Code.

Qualification Sanctions. The bill imposes a new sanction for violation of the qualification requirements that currently appear in Section 89(k). Under the bill, an employer with a plan that violates the qualification requirements will be subject to an excise tax of 34 percent of the amounts paid or incurred under the plan during the year.

We consider the excise tax to be a more appropriate sanction than the adverse income tax consequences that current law imposes on employees. However, the 34 percent tax rate is excessive, and is far higher than the marginal income tax rate that applies to a typical employee under current law. Furthermore, because the excise tax applies to all of the amounts paid or incurred under the plan, the base against which the tax is applied normally will be wholly disproportionate to the severity of the violation. We strongly urge that a more refined and discriminating approach be applied.

When Congress originally enacted the "COBRA" health care continuation requirements, it imposed a similarly undiscriminating sanction (disallowance of all the employer's health expense deductions), and soon found it necessary to adopt a more refined approach. We urge the Committee to adopt a more refined approach from the outset in this case.

Taft-Hartley Plans. As described in the immediately preceding comment, the bill imposes a 34 percent excise tax upon an employer that participates in a plan that violates the qualification requirements. Imposing a penalty on the employer is unjustified where the employer participates in a Taft-Hartley plan that is administered by an independent board of trustees. Under a Taft-Hartley plan, the trustees are required by ERISA to act independently; they are not the agents of the union or the participating employers. See NLRB v. Amax Coal Co., 453 U.S. 322 (1981). Accordingly, the bill should be revised to provide that the tax does not apply to an employer merely because it participates in a Taft-Hartley plan that violates the qualification standards.

Section 501(c)(9) Trusts. Under current law, a voluntary employees' beneficiary association ("VEBA") that is exempt from tax under Section 501(c)(9) is subject to an excise tax if a "discriminatory employee benefit plan (within the meaning of section 89) is part of" the VEBA. The bill should make clear that as long as the employer satisfies the bill's broad availability requirement, the excise tax will not be applied simply because some highly compensated employees are required to recognize income pursuant to the bill's 133 percent test. If an employer makes affordable core health coverage available to the specified percentage of its non-highly compensated workforce, the employer should not be considered to maintain a "discriminatory employee benefit plan" for purposes of the excise tax.

Valuation. The bill provides that the value of coverage provided by a health plan will be determined under procedures to be prescribed by the Treasury. The bill should be revised to allow an employer to elect to use premium cost as determined under the health care continuation rules or to use any other reasonable valuation method in lieu of employer premiums. This approach is permitted, but only on a temporary basis, by the Internal Revenue Service's proposed regulations; it permits employers to use the valuation method that is most appropriate to the circumstances of their individual plans and, where appropriate, to rely on the same method that they use for health care continuation purposes.

Legal Enforceability. The bill makes no substantive change in the requirement currently imposed by Section 89(k)(1)(B) that an employee's rights under a plan be "legally enforceable." However, the Internal Revenue Service's proposed regulations have taken the "legally enforceable" requirement to an unnecessary and impractical extreme. Many employee benefit plans, and health plans in particular, inevitably call for the application of judgment and discretion in plan administration. For example, a health plan might exclude coverage for "experimental" or "cosmetic" procedures. Although these terms are not defined precisely, they are legally enforceable. If the provisions are administered in an arbitrary or inconsistent manner, an employee who is adversely affected will be in a position to enforce his right to obtain coverage under the plan.

The regulations do permit the exercise of "administrative discretion," but only to the extent that the discretion is based solely on "clearly defined and ascertainable criteria." The bill should provide that the legal enforceability standard does not always require that discretion be exercised under "clearly defined and ascertainable criteria" and that the application of judgment and discretion under objective and nondiscriminatory guidelines is permissible.

Dependent Care. The bill provides that group-term life insurance benefits will be subject to the nondiscrimination provisions established by prior law, but fails to include a comparable provision for dependent care assistance. The bill should provide that dependent care assistance also will be governed by the nondiscrimination standards in effect prior to the enactment of Tax Reform.

Effective Date of Employee Notification Requirements. The Internal Revenue Service's proposed regulations provide that the employee notification requirement currently imposed by Section 89(k)(1)(C) requires notice to be given by July 1, 1989, in most cases. *See* Prop. Treas. Reg. § 1.89(k)-1, Q&A-5(g)(4). Although the Tax Reform Act was enacted in October of 1986, the Service did not issue its proposed regulations until March of this year, approximately two and one-half years later. In view of this delay, it is essential that the Congress extend, until January 1, 1990, the deadline for compliance with the notification requirement. Employers cannot reasonably be expected to comply with the notification requirements within the truncated four-month period allowed by the proposed regulations.

Phased Implementation. The bill is effective in 1990 and permits an employer to choose either current law or the new rules for 1989. In most instances, however, compliance with current law is a recordkeeping and data collection nightmare and an impractical alternative for 1989. Although the bill's nondiscrimination standards do not present the same practical difficulties for future years, it is now too late for employers to adjust their plans retroactively to the beginning of 1989 to comply with the bill. Accordingly, the Committee should phase in the standards imposed in the bill by prescribing less stringent standards for 1989.

Mr. Chairman, we thank you for giving us an opportunity to present our views to the Committee. Our views are the result of the analysis of the bill that we have conducted to date. We will continue to study the bill and look forward to continuing to share our thoughts with the members of the Committee and their staffs. We will be happy to respond to any questions that you or the other members of the Committee might have.

Mr. **Levin**. Thank you very much.
Mr. Marshall.

STATEMENT OF DAVID G. MARSHALL, VICE PRESIDENT, EMPLOYEE BENEFITS, RJR NABISCO, INC., ON BEHALF OF SECTION 89 COALITION AND THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. **Marshall**. Good afternoon, Mr. Chairman and members of the committee. My name is David Marshall, and I am vice president of employee benefits for RJR Nabisco. My appearance today is on behalf of the Section 89 Coalition and the Association of Private Pension and Welfare Plans, the APPWP. The APPWP, of which I am an officer, is a private, nonprofit organization whose primary purpose is to protect and foster the growth of this country's private pension and employee benefit system. The APPWP was founded in 1967 and has grown since that time to represent hundreds of plan sponsors, both large and small, as well as the leading support organizations to the benefits community.

The Section 89 Coalition is a voluntary coalition of both large and small employers, managed health care plans, insurers, and benefit consultants that have banded together to communicate their concerns relative to section 89.

We are very pleased to be able to testify today on a bill intended to ease the unnecessary and burdensome requirements of current law. We share the implicit belief that tax-favored benefits should be provided in a fair and equitable manner, without the needless and counterproductive waste of resources that would be required to comply with well-intentioned by incredibly complex rules.

The APPWP and the Section 89 Coalition have long advocated a sensible and workable approach to achieving these important goals, and accordingly, we congratulate the chairman and the other sponsors of H.R. 1864 for a bill that is not only straightforward and comprehensible to the layman, but also primarily bases its testing on the availability of benefits as we have long urged.

We think that the affordability concept as applied to employee contributions is a positive step. We also commend you for recognizing that rules designed for health benefits do not work when extended to other benefits.

As we reviewed H.R. 1864, we attempted to keep in mind some guideposts for the essential elements of any bill that is designed to solve the problems that exist in current law. While a nondiscrimination test ought to hold employers to the standard of making coverage widely available, it should not confine the employer's choice of arrangements or delivery method. Employers in this country are diverse. This diversity is economic, geographic, industry-specific, and profit divergent. Some industries rely heavily on secondary wage earners; others are seasonal; others are primary employers of youth or part-time workers. Offering uniform benefits to all of our employees does not make sense for competitive reasons. For reasons of their own, our employees are not seeking and do not want uniform benefit arrangements. Our businesses and our employees require flexibility; the code should not restrict this need. As the face and mobility of the U.S. work force continues to change, the need for flexibility in the provision of benefits grows. Most importantly, failure to permit flexibility will not produce the desired result of making benefits available. Rather, it will cause reduced coverage and diminished plan quality.

We should also realize most vividly from our experience with section 89 that efforts to adopt complex rules that deal with every problem and attempt to address every situation are not productive. Rules which are unadministerable will not advance the cause of nondiscrimination.

As to the specifics of H.R. 1864, we are well satisfied with the bill's design-based approach that focuses on a plan that provides primarily core benefits. So long as we are able to fully aggregate core plans, including similar plans with different eligibility periods, we think this rule will be very workable.

Next, the use of the 25-hour standard for part timers is far more realistic than current law, and the ability to prorate the employer-provided benefit for part-time employees is also welcome. However, we would urge a phasing-in of any new part-time standard along the lines envisioned in Senate 654 introduced by Senator Pryor.

We would also mention that we are gratified to see the line of business, operating unit, and separate geographical location concepts in H.R. 1864.

The ability to test union plans separately is also a start in the right direction, although we would urge that you consider adopting the pension example which allows employers to include union employees or not, as the case may be.

I would reemphasize that while we truly believe that H.R. 1864 is a step in the right direction, we are not without concerns with the bill. These concerns fall into four major categories. The first that I would identify is the so-called cliff effect associated with the 90 percent test; next is what represents the proper measure of how a plan is deemed affordable; third, the ability to prove nondiscrimination if a plan fails the availability test; and, finally, what can only be described as the bill's severe treatment of flexible benefit arrangements.

Remarks and suggestions with respect to each of these concerns are contained in our full testimony. I have summarized here, and I would be pleased to stop at this point and thank you for allowing us to appear today.

[The statement of Mr. Marshall follows:]

STATEMENT OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Good Morning, Mr. Chairman and members of the Committee. I am David G. Marshall, Vice-President, Employee Benefits, RJR Nabisco. My appearance today is on behalf of the Section 89 Coalition and the Association of Private Pension and Welfare Plans ("the APPWP"). The APPWP, of which I am an officer, is a private, non-profit organization whose primary purpose is to protect and foster the growth of this country's private pension and employee benefit system. The APPWP was founded in 1967, and has grown since that time to represent hundreds of plan sponsors, both large and small, as well as the leading support organizations to benefit plans such as investment firms, banks, insurance companies, accounting firms, and actuarial and benefit consulting firms.

The Section 89 Coalition is a voluntary coalition of both large and small employers, managed health care plans, insurers and benefit consultants that have banded together to communicate their concerns about section 89 to the Congress and the Administration.

We are very pleased to be able to testify today on a bill that may ease the unnecessary and burdensome requirements of section 89. We share the implicit belief that tax-favored benefits should be provided in a fair and equitable manner, without the needless and counterproductive waste of resources that would be required to comply with well-intentioned but misdirected regulation.

The APPWP and the Section 89 Coalition have long advocated a sensible and workable approach to achieving these important goals, and accordingly, we congratulate the Chairman and the other sponsors of H.R. 1864 for a bill that is not only straightforward and comprehensible to the layman, but also primarily bases its testing on the availability of benefits, as we have long urged. As the statement accompanying the introduction of H.R. 1864 pointed out, it will reduce some recordkeeping and will also place the sanctions for noncompliance with the qualification requirements on the employer, where they should be; not on the employee. We think that the affordability concept as applied to employee contributions is a positive step. We also commend you for recognizing that rules designed for health benefits do not work when extended to other benefits.

OVERVIEW

As we reviewed H.R. 1864, we attempted to keep in mind some guideposts for the essential elements of any bill that is designed to solve the problems that exist in the current section 89. While a nondiscrimination test ought to hold employers to the standard of making coverage widely available, it should not confine the employer's choice of arrangements or delivery method. Employers in this country are diverse, and even within companies there is a great deal of diversity. That diversity is economic, geographic, industry-specific and profit divergent. Some industries rely heavily on secondary wage earners; others are seasonal; others are primary employers of youth or part-time workers. Offering uniform benefits to all of our employees doesn't make sense for competitive reasons. For reasons of their own, our employees are not seeking and don't want uniform benefit arrangements. Our businesses and our employees require flexibility; the Code ought not restrict this need. As the face and mobility of the U.S. workforce continues to change, the need for flexibility in the provision of benefits grows. Most importantly, failure to permit flexibility will not produce the desired result of making benefits available. Rather, it will cause reduced coverage and diminished plan quality.

We should also realize most vividly from our experience with section 89 that the continued trend to adopt complex rules that deal with every problem, and attempt to address every situation is not productive. Rules which are unadministrable will not advance the cause of non-discrimination.

H.R. 1864: A POSITIVE STEP TOWARD SECTION 89 REFORM

Turning to the specifics of H.R. 1864, I want to first emphasize that there is a lot to like in this bill and we are largely pleased with the direction you have taken. We are satisfied with the bill's design-based approach that focuses on a plan that provides primarily core benefits. So long as we are able to fully aggregate core plans, including similar plans with different eligibility periods, we think this rule will be workable. This kind of approach generally will allow employers to revise their plans to make employee contributions comply with the rule, rather than fiddling with value and forcing employees into benefit structures that they neither want nor need. We think that the availability standard is the most workable approach in this area and we applaud its use in your bill.

The use of a 25 hour per week standard for part-timers is more realistic than current law, and the ability to scale down the employer-provided benefit for part time employees is also welcome. We differ with you on whether that ability ought to begin at 30 hours, as the bill is currently drafted, or at 37 1/2 hours, which is the much more commonly accepted minimum for full-time, but we are gratified to see that the bill forgoes the previous 17 1/2-hour part-time standard. For many firms for which including part-time workers in section 89 testing is a problem -- it is a great problem. Therefore, we urge a phasing-in of the new part-time standard along the lines envisioned in S. 654 introduced by Senator Pryor and other Finance Committee members: 30 hours in 1989; 27-1/2 hours in 1990; and 25 hours in 1991.

We are delighted to see group-term life insurance removed from section 89. It didn't fit and most of us -- including the Treasury and IRS -- simply could not understand how to make the rules work for this kind of benefit. On the "if it ain't broke, don't fix it" theory, we will be satisfied to return to the prior law nondiscrimination rules in section 79.

We are also gratified to see the line of business, operating unit, and separate geographical location concepts in H.R. 1864. The 35 mile rule was a much-heralded improvement to section 89, and this rule, along with the ability to treat separate units differently, is absolutely critical where the costs of health care vary so enormously from location to location, and the needs of a particular workforce are so divergent from the needs of another. We are concerned, however, that there are still no regulations or other guidance on lines of business from the Treasury and although Code section 414(r) requires that under certain circumstances, a plan sponsor must obtain a ruling from the Treasury in order to rely on a separate line of business, the Treasury is not even accepting such ruling requests. We urge that H.R. 1864 specifically provide that an employer may make reasonable, good faith judgments until final regulations are issued by the Treasury.

The ability to test union plans separately is a start in the right direction although we urge you to consider adopting the pension example to allow employers to exclude union employees or not. The pension rules clearly make these units excludable and no abuse has been cited. The leeway we seek in this area is important and necessary -- different kinds of union plans and different proportions of union coverage require a more flexible approach and we hope that you will adopt one. Nonetheless, the start that you have made on this subject is far preferable to the current section 89 approach.

Finally, permitting employers the ability to choose to comply with current section 89 or the law as amended by this bill for 1989 is an approach that seeks to avoid penalizing those who have begun complying with section 89. However, quite clearly, the year will be nearly over by the time this bill or another becomes law. To require the application of either the very confused and complex current section 89 rules, where further guidance is not even anticipated and the guidance we now have is simply not enough, or a new bill, that is enacted so far into the year that employers cannot reasonably be expected to redesign their plans to meet a design-based test, is not a reasonable solution. The desire to protect those who have attempted compliance is understandable but fails to recognize the fact that the law has been unsettled since its passage and many employers simply sought to wait until technical corrections and/or regulations were issued. This was not an unreasonable response, especially where a misinterpreted provision could cost an employer thousands of dollars to correct. We urge prompt action if these requirements are to be effective this year. At least some consideration should be given to legislative deferral of the section 89 requirements or their enforcement for 1989, with any new changes to the statute effective for 1990.

OTHER ISSUES RAISED BY H.R. 1864

While we truly believe that H.R. 1864 is a step in the right direction, we are not without concerns with the bill. They fall into four major categories: the cliff effect of the 90% test; and the proper measure of how a plan is deemed affordable; the inability to prove non-discrimination if a plan fails the availability test; and what can only be described as the bill's severe treatment of flexible benefit arrangements.

THE 90% TEST

H.R. 1864 provides that highly compensated employees will be permitted to exclude a certain portion of employer-provided benefits from income so long as the employer makes available a plan or plans which, in the aggregate, offer core health coverage to 90% of the non-highly compensated employees at an affordable price. We have two problems with this standard. The first is that 90% is unreasonably high -- far higher than any other availability test under current law. Especially in the context of the required exclusion of union employees for this purpose, the required availability level needs to be reduced.

Secondly, the 90% availability test creates a cliff effect: availability to 90% of an employer's non-highly compensated employees allows the highly compensated to receive a tax benefit; availability to 89% allows them none. The effect of an unknowing failure is simply too great. A phase-out makes far more sense. For example, where the employer fails by too wide a margin, it is appropriate that the tax benefits disappear.

The cliff effect is made even more exaggerated by the rule that a highly compensated employee's taxable benefit is the difference between what he receives and 133% of the lowest benefit received by 90% of the nonhighly-compensated. Most large employers will not be able to establish one core benefit plan for all of their non-highly compensated employees and even where their group of plans are providing identical benefits they will not be comparable in cost for geographic or experience reasons.

Aggregating these different plans to meet the 90% test will require employers to use the lowest employer-provided benefit in the group of aggregated plans as the base from which the nontaxable benefits of each of the highly-compensated are determined. This approach unnecessarily heightens the cliff effect of the rule.

As an alternative we suggest that you move to the section 401(k) model of using average benefits provided to lower-paid employees to determine the maximum available tax-free benefit. This will be a more workable rule for plans which are fairly offered to employees but differ in benefits for valid business reasons, such as where the employees have selected the least expensive delivery system, or where profit margins or a firm's competitive position lowers the employer-provided benefit.

THE AFFORDABILITY STANDARD

H.R. 1864 defines affordability by reference to the required employee contribution. The standard set forth in the bill is $10/week for individual coverage and $25/week for family coverage. These dollar limits would be indexed with the Social Security wage base. Since medical inflation is so rapidly outpacing the rise in wages, the method of indexing prescribed in H.R. 1864 will shortly become of little utility to plans. A simple example will explain this problem.

Assume that medical inflation will continue to rise at the approximate current rate of 10% and that wages will continue to grow at around 5%. Assume further that the $10/week standard for individual coverage represents 20% of plan costs, making the employee and employer contribution $10 and $40 per week respectively. Assume that the new standards take effect in 1990. By 1991 the employee contributions will represent 19.3% of costs of the entire plan; by 1995, 16.5%, and by the year 2000, 13.6%.

The natural employer response to this situation will not be to shoulder more costs but, instead, to reduce coverage. Moreover, using a national wage standard for indexing unfairly penalizes those employers who provide higher than average wage increases.

Accordingly, we would suggest that you alter the current approach in H.R. 1864. Either the indexing should be changed to the medical component of the Consumer Price Index or the approach should move to one based on a percentage of the cost of the plan. We recognize that you might have a concern that the costs for employees could become too high of a percentage of wages or reach a level higher than your proposed dollar amounts indexed to the medical component of the CPI would produce. However, the test could factor those concerns into the limit by setting a maximum dollar level or percentage of plan cost. We would be delighted to work with you in any way you think most useful to arrive at an approach that will remain realistic over time. However, a solution that works for only a year or two is no solution at all.

ABILITY TO PROVE NONDISCRIMINATION

One of the problems with section 89 as it now exists is that it requires plans to be subjected to a rigorous series of costly tests -- often, of course, only to prove what the plan sponsor knew already: the plan does not discriminate. Thus, the design-based availability test in H.R. 1864 is a significant improvement. Unfortunately the rigidity of a single availability test to be applied to a myriad of different health plans serving different employee populations in different industries in different regions of the country with different health care cost pressures makes the test problematic in a number of instances.

For example, a health plan that actually covers 100% of the employees far exceeds the 90% availability standard and clearly does not discriminate, but could fail under H.R. 1864 if the employee contributions were more than $10 a week. This would occur even where the reason for the higher employee contribution was that the plan included more benefits and/or was provided in a comparatively higher health care cost region. Likewise, a plan might require no employee contributions whatsoever, but only would be available to 89 percent of the non-highly compensated employees. No one would logically consider such a plan to be discriminatory, yet it, too, would fail the "eligibility" test.

The challenge, then, is to avoid these anomalous results without once again injecting complexity into the testing process for nondiscrimination. We suggest that H.R. 1864 be modified to allow a truly simple coverage test to be applied as an option to the application of the "eligibility" test in H.R. 1864. As long as such a test were offered as an option to an employer who wished to prove that its plan was nondiscriminatory, the risk of perpetuating the current difficulty of the law could be avoided. Since many truly nondiscriminatory plans will not fit within the confines of certain eligibility tests, no matter how well designed, an option to apply a coverage test would meet our mutual goal of ensuring nondiscrimination. We would be pleased to work with you on this effort.

FLEXIBLE BENEFIT ARRANGEMENTS

Our final remarks are directed to the effect of the bill on flexible benefit arrangements funded through salary reduction, and how H.R. 1864 undercuts even its own notion of affordability. It should go without saying that the growth of flexible benefit arrangements represents one of the most positive trends in the employee benefits field. These plans offer employees a choice to direct benefits dollars to the types of benefits that meet their needs. On a number of occasions Congress has acted to foster this choice. Because these types of plans are so worthwhile, and because they have traditionally enjoyed Congressional support, we are concerned with the impact of H.R. 1864 on these plans.

The bill provides that salary reduction amounts used in flexible spending arrangements and flexible benefit plans will be treated as employee contributions for the nonhighly-compensated, and as employer contributions for the highly-compensated. The presumed theory for according disparate treatment of salary reductions is that failure to do so might enable employers to forego appropriate levels of funding and make nonhighly-compensated employees bear a greater proportion of costs. But this theory ignores the fact that the tax benefit of an employee contributing to his health care arrangements with pre-tax dollars makes the arrangement more affordable, and thus, in this context, more available. While we recognize that there are revenue consequences to be considered, there needs to be an accommodation so these plans may continue to operate. There are probably numerous alternatives that would achieve a reaonable solution and strike a balance between the Committee's policy concerns, and employer and employee interest in retaining salary reduction as an efficient delivery system to attain cost containment. In the past there have been efforts to eliminate or to cap salary reductions to flexible benefit plans and each time, both employer and employee groups have put forth convincing arguments why these arrangements encourage responsible health choices. We don't think that the issue should be revisited, certainly not in the context of H.R. 1864, but we are certainly prepared to supplement our testimony in any way that would be helpful to the Committee, to explain all the reasons why any new nondiscrimination rules for welfare plans should not effectively eliminate salary reduction as a means of reducing the cost of health care to employees.

Again, we would be eager to work with your Staff to find a solution to this problem, but we feel strongly that flexible benefit plans must be allowed to continue on a viable and effective basis.

We appreciate the opportunity to appear before you today and our members will be happy to work with you to make your bill one that we can all support.

Mr. LEVIN. Thank you very much, Mr. Marshall.
Mr. Hoffman.

STATEMENT OF ARTHUR S. HOFFMAN, CHAIRMAN, FEDERAL TAXATION EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOMPANIED BY DEBORAH WALKER, CHAIRMAN, SECTION 89 TASK FORCE

Mr. HOFFMAN. Thank you, Mr. Levin.

I am Arthur S. Hoffman, chairman of the executive committee of the tax division of the American Institute of CPA's. I have had the privilege of testifying before this committee and the Subcommittee on Oversight chaired by Chairman Pickle several times over the years on a wide variety of subjects. However, today is different. Today, the subject is section 89, and section 89 presents problems unlike any other tax provision, even to the experienced tax practitioner.

To illustrate, section 89 falls within the scope of our subcommittee on employee benefits, and this subcommittee is made up of 16 members, all of whom are highly knowledgeable in the area. But the subcommittee did not want responsibility for section 89. The provision is so problem filled that the tax division was obliged to appoint a special section 89 task force. We asked them to devote their attention to helping our membership understand the provision and to propose changes so that it can be applied by the mere mortals among us.

I am knowledgeable enough on the subject of section 89 to be able to congratulate the chairman on introducing H.R. 1864. We support its approach to fulfilling the goal of extending health coverage free of discrimination. It is immeasurably superior to section 89 in its present form. In large part, it does remedy the complexities of section 89. Those complexities, in the end, would have had two unfortunate results: the fostering of noncompliance for the sheer lack of comprehension, and in too many cases the termination of health plans instead of the extension of benefits to the rank-and-file.

For commentary on H.R. 1864 beyond my general remarks, I turn to the chairperson of our section 89 task force who has worked tirelessly over the last year with other organizations and your staff to streamline section 89 and make it understandable and administrable. I would like to introduce Deborah Walker.

Ms. WALKER. Thank you.

Mr. Chairman, the AICPA applauds Chairman Rostenkowski for proposing legislation which significantly reduces an employer's compliance costs. Our greatest concern was that section 89 was so significantly complex that we had widespread misunderstanding of the rules and excessive compliance costs. That would eventually lead to enforcement problems within the IRS and eventually to noncompliance.

We think that Chairman Rostenkowski's bill eliminated all of that, and for this reason, it is much better tax policy than the existing section 89.

We are concerned, however, with three major aspects of H.R. 1864: the treatment of cafeteria plans, the inflexibility of the 90-

percent eligibility requirement, and the definition of an affordable plan. The proposed legislation will, we believe, discourage adoption of cafeteria plans. We also believe that in today's society, with two-earner families, we should, in fact, allow employees a choice with respect to the benefits they wish to receive, and for that reason, cafeteria plans should be, if not encouraged, certainly not discouraged by legislation.

We understand the chairman's concern in providing employer-provided benefits without salary reduction, and for that reason, we recommend a change in salary reduction health plans, a separate discrimination test that would apply to those plans and those plans alone.

The proposed legislation includes an inflexible 90-percent eligibility test. We recommend lowering that standard. We recommend a phase-in of the penalty for failing the standard, or we recommend that the committee adopt a grace period within which an employer can correct inadvertent failure should he fall below the 90-percent test. We understand that widespread eligibility is a goal of the proposed legislation, but we do believe that employers significantly failing that requirement should pay a higher penalty than employers failing the standard by a narrow margin.

We notice that the changes with respect to part-time employees will mitigate these concerns. More changes are needed with respect to the leased employee provisions.

Finally, the adjustment of the $10 and $25 standard by wage increases will, in the very near future, result in an allowable employee contribution that is below what most reasonable health plans are going to require. Medical costs, as we all know, are increasing much more rapidly than wages. Employers, in fact, do have limited budgets for health benefits, and cost-sharing is something that most employers are going to demand. The $10 and $25 limits will effectively cap an employee's contributions, and that will force employers to offer less rich plans to employees in order to meet the test. We recommend that a percentage of the employer's premium, perhaps limited to not more than a certain percent of the wages, be used rather than the flat dollar amount. This eliminates the need for cost-of-living adjustments, and it more accurately reflects the true cost of benefits for large employers and small employers alike, for regional differences as has been mentioned before.

As I said earlier, we generally support this legislation and believe it goes far toward solving the current IRC section 89 compliance problem which many employers face today.

Thank you.

[The statement of Mr. Hoffman follows:]

STATEMENT OF ARTHUR S. HOFFMAN
CHAIRMAN OF THE
FEDERAL TAXATION EXECUTIVE COMMITTEE OF THE
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

INTRODUCTION

The American Institute of Certified Public Accountants greatly appreciates this opportunity to offer comments and recommendations prepared by our Federal Tax Division on H.R. 1864, a bill to simplify the nondiscrimination rules applicable to employee benefit plans under section 89 of the Internal Revenue Code.

The AICPA is the national, professional organization of CPAs, with over 280,000 members. Many of our members are tax practitioners who work with millions of American taxpayers, both individuals and businesses. We are deeply concerned with the effect of section 89 upon businesses of all sizes, in all sectors of the economy.

The AICPA applauds the Chairman on a bill that significantly limits compliance costs by focusing on plan availability rather than plan coverage. Given that the cost of compliance was the AICPA's most significant concern with existing IRC section 89, we generally support the proposed legislation with only a few changes, such as the treatment of salary reduction or cafeteria plans and the appropriate indexing of employee contributions for a qualified core health plan. While we will make a number of suggestions for changing the proposed legislation, we want to make it clear that we generally support the approach presented.

We have received hundreds of calls from CPAs requesting assistance in implementing section 89 for their clients. Many of our members report that their clients, both small and large, are finding the statute too complicated to interpret and far too expensive to administer. We believe that the end result of these tests will be relatively minor changes to an individual's Form W-2. This is an instance where the cost of compliance far outweighs any benefit derived from the resulting information, even for the Treasury Department.

In November, we mailed to our 22,000 Tax Division members a copy of our 15-page practice guide which focused on the small business entity which has only one employee plan; thus, it did not encompass most of the complexities of section 89 which are proving to be literally unworkable. Even in the relatively simple situation described in our practice guide, there were many questions which remained unanswered.

Many taxpayers are unable or unwilling to understand the rules. They are seriously considering whether to eliminate some or all of their employee health coverage. Others plan to eliminate the tax preferred health coverage for highly compensated employees (HCE). These are both extreme reactions to tax legislation which requires far too much data collection and manipulation. While the reactions may not be appropriate, they are occurring nonetheless.

The complexity of these rules has resulted in widespread misunderstanding of the provisions and will lead to growing enforcement problems for the Internal Revenue Service. Section 89 is a notable example of the inevitable linkage of complexity and noncompliance.

Large employers incur tremendous costs in complying with section 89. One employer, a Fortune 100 company with 45,000 employees in 2,000 locations, must test approximately 300 "plans" under section 89. As a result of the test, some 1,500 highly compensated employees will recognize additional income of approximately $650,000. To calculate the additional income to be recognized, the employer has incurred additional consulting fees of $260,000 through December 31, 1988. This does not include the additional costs incurred within the corporation in compiling the data. Annual expected cost to this employer for testing and documentation is $250,000. No new or increased health benefits were provided to employees since the cost of the increased benefits far exceeds the tax burden to the highly compensated with respect to this additional section 89 gross income.

Comments on general approach of H.R. 1864

Although we are suggesting a number of changes for the proposed legislation, we want to make it clear that we generally support the approach presented. The testing of discrimination with an availability test is far superior to using a coverage test. We agree with H.R. 1864's change in definition of part-time employees from those working at least 17 1/2 hours to those working 25 hours; however, the proportional allowable increase in employee contributions should be based on a 40-hour week not a 35-hour week. We generally agree with H.R. 1864's reversion (with minor modification) to pre-1986 Tax Reform Act law for the group term life insurance discrimination tests. We also agree with the delay in testing former employees but would suggest a permanent exclusion of these employees from the rules. We agree with the elimination of the rule that requires every employer to have at least one highly compensated employee. This is especially helpful for small tax exempt and governmental employers.

The treatment of salary reduction amounts under the proposed legislation discourages the adoption of cafeteria plans

Amounts funded through salary reduction arrangements are treated as employee contributions for purposes of the eligibility test. Thus, salary reduction amounts may not exceed the $10/$25 limitation on employee contributions for the plan to be a qualified core health plan. This treatment of salary reduction amounts recognizes that salary reduction represents a cost to the employee. Accordingly, the required employee contribution funded through salary reduction is viewed in the same manner as a required employee contribution not funded through salary reduction in determining whether a plan is affordable to nonhighly compensated employees.

For purposes of the benefits test, salary reduction is treated as an employee contribution rather than as an employer provided benefit included in the base amount for applying the 133 percent factor. Consequently, salary reduction made available to or utilized by nonhighly compensated employees (NHCE) does not increase the level of coverage that can be received by the highly compensated employees under the benefits test.

For purposes of determining the taxable benefit of a highly compensated employee, salary reduction amounts are considered employer provided benefits. Thus, to the extent that these amounts, when added to other employer-paid coverage, exceed the 133 percent limitation imposed by the benefits test, the salary reduction is included in the taxable income of the highly compensated employee thereby nullifying his salary reduction.

For example, assume an employer offers a salary reduction plan with three benefits available through salary reduction: core plan II, valued at $2,000, medical reimbursement and a dental plan. All employees are provided, on a nonsalary reduction basis, with core plan I which is valued at $1,000.

	Core Plan I	Core Plan II	Medical Reimbursement	Dental Plan
Annual Plan Value	$1,000	$2,000	$500	$400
Single Employee Annual Salary Reduction Cost	0	900	500	400
Employer Provided Benefit	$1,000	$1,100	$ 0	$ 0
Percent of NHCE's Eligible	90	90	90	90
HCE Taxable Benefit	0	670	500	400

If a highly compensated employee reduces his salary for $900 in order to participate in core plan II, he will realize a taxable benefit of $670 ($2,000 - (1.33 X $1,000)). If a highly compensated employee reduces his salary for core plan II, the medical reimbursement and the dental plan, his taxable benefit would be $1,570 ($2,900 - (1.33 X $1,000)). A highly compensated employee electing only medical reimbursement would have a taxable benefit of $170 ($1,000 + 500 - $ 1,330). It should be noted that in this example, highly compensated employees get no benefit from the salary reduction amount beyond the additional 33 percent of the core health coverage provided. This is the result even though all health plans are equally available and the employer has made an affordable core health plan (core plan I) available to more than 90 percent of nonhighly compensated employees.

We believe that this treatment of salary reduction will discourage the use of cafeteria plans in providing health benefits by eliminating the tax favored status of such contributions with respect to highly compensated employees. The AICPA believes that cafeteria plans which offer employees a choice in designing their benefit package are desirable and that the tax law should not discourage the provision of such programs. Any discrimination tests in this legislation should not favor nonsalary reduction health plan contributions any more or less than salary reduction health plan contributions.

Suggestions for changing the testing with respect to salary reduction amounts

Within the basic framework of H.R. 1864, there are a number of alternatives for testing salary reduction amounts. The legislation could allow for inclusion of salary reduction amounts in the employer provided benefits for purposes of calculating the 133 percent limitation if employees can only receive cash if they have core medical coverage elsewhere, such as through another employer or the employer of the employee's spouse or parents. The treatment of salary reduction amounts should be consistent in calculating the $10/$25 limitation and the 133 percent limit.

Alternatively, the legislation could allow the average salary reduction for all nonhighly compensated employees to be considered an employer provided benefit for purposes of calculating the 133 percent limitation.

More simply, the legislation could increase the 133 percent factor to perhaps 200 percent. With this much allowable disparity, cafeteria plans would not find the tests as onerous.

Another alternative would be to revert to the salary reduction rules of TAMRA (The Technical and Miscellaneous Revenue Act of 1988) as a means of monitoring the abuses with cafeteria plans.

We believe the best alternative is to exclude health benefits provided under cafeteria plans from these discrimination tests. If additional discrimination tests are needed in IRC section 125, a benefits test for all nontaxable benefits elected under the plan might be appropriate.

We believe, as is reflected in H.R. 1864, that salary reduction amounts are inherently different from traditional employer provided health benefits and thus should be subject to different discrimination tests. We also believe that the tests should include all benefits available within the cafeteria plan so that employees are not penalized by the choice of a specific benefit.

The 90 percent eligibility test should be modified

We believe that the 90 percent eligibility test, which represents a good approach, also results in inequities for employers who are slightly below the 90 percent cutoff. We suggest that this could be alleviated in any of several ways:

- lower the percentage;
- include a graduated penalty schedule;
- eliminate leased employees from this calculation; or
- provide a grace period for employers who substantially meet the eligibility rules.

A lower required eligibility percentage would increase the number of employers with qualified core health plans. It is unclear why health plans are subject to more restrictive rules than the 70 percent rule of pension plans.

A phase-in of the penalty for failing the eligibility test, such that a smaller taxable benefit accrues to employees of an employer who covers more than 70 percent of nonhighly compensated employees than one who covers less than 70 percent of nonhighly compensated employees, would be more equitable. While this would involve additional complexity in the legislation, we believe such complexity may be warranted so that highly compensated employees are not unduly burdened where a plan does not satisfy the 90 percent test by a small margin.

Elimination of leased employees from the testing would also help employers satisfy the 90 percent eligibility test. While we are aware that such employees can be disregarded where the lessor makes qualified core health coverage available, we are doubtful that a lessor's coverage can easily be considered by the lessee in its testing.

A grace period could be provided for employers who fall below the required 90 percent eligibility standard by a certain margin. It is possible for an employer who has met the 90 percent test in prior years to fall slightly below that level due to such things as mergers or unexpected rapid growth in employment. These employers could avoid all penalties for the first year such eligibility test was not met, giving them time to comply. For 1989, the grace period could apply to all employers.

Alternatives to $10/$25 limits would be a better measure of affordability

The $10 and $25 limits are not properly adjusted for cost of living increases. In the very near future more and more employers will fail to satisfy the $10/$25 affordability standard because medical costs are increasing at a much greater rate than wages. Many small employers with higher health insurance costs because of their relatively small groups already find these rates inadequate. As the cost of health premiums increase, employers will be forced to pay a higher percentage of the cost, offer a plan which no longer qualifies as a qualified core health plan or lower the value of the qualified core health plan offered.

While we understand that an affordability test should be related more to wages than to medical costs, we believe that the law must recognize that employers also have limited resources to put into health plans. If employees cannot share future increases in medical premiums, it is quite likely that coverage will be reduced or plans discontinued. A limit on increasing the employee cost for a qualified health plan will decrease the incentive for providing health coverage in the near future.

We believe that using a percentage of total premium costs to determine an affordable plan, perhaps not to exceed a certain percentage of an individual's wages, would add needed flexibility to the affordable plan defined in the proposed statute and put the small employer more at parity with the large employer. Tying the allowable employee cost to a percentage of the employer's total premium cost would ensure that it would keep pace with medical inflation and with that particular employer's cost for group coverage. Adding the percentage of compensation cap would ensure that non-highly compensated employees do not pay too great a portion of their wages for health benefits.

For example, assume the maximum employee contribution is the lesser of 40 percent of premium or 5 percent of wages. Assume wages increase 2 percent per year and medical premiums increase 25 percent per year.

	Year 1	Year 5
Premium	$1,000	$3,050
40 percent of premium	400	1,220
Employee A		
Wages	$10,000	$11,040
5 percent of wages	500	552
Maximum contribution	400	552
Employee B		
Wages	$30,000	$33,122
5% of wages	1,500	1,656
Maximum contribution	400	1,220

As this indicates, the very low paid employee is protected by the 5 percent wage cap, while the $30,000 employee would continue to contribute the 40 percent of premium. The additional premium for the $10,000 employee would be absorbed by the employer. However, with other employees sharing the increased costs, this arrangement will encourage employers to maintain reasonable health plans.

Defining the affordable plan as a percentage of the health premium will not penalize the employer who wants to offer a very generous plan with a required employee contribution of more than the $10 or $25. One of the inappropriate results of the proposed legislation is that the highly compensated employees have a taxable benefit for all health coverage which is not available through an "affordable" plan. This results even if the employer makes available an affordable plan and a more expensive plan on an equal basis.

For example, assume an employer offers to all employees on a nonsalary reduction basis, two core health plans, (core plans I and II), a dental plan and a vision plan with the following annual required employee contributions.

	Core Plan I	Core Plan II	Dental Plan	Vision Plan
Annual Plan Value	$ 950	$2,000	$350	$400
Single Employee After Tax Annual Cost	450	900	150	300
Employer Provided Benefit	$ 500	$1,100	$200	$100

An employee can participate in one of the core plans and the dental and vision plans. If a highly compensated employee participates in core plan I, the dental plan and the vision plan, a total employer provided benefit of $800 ($500 + $200 + 100) will be received, of which $135 ($800 - (1.33 X 500)) would be taxable. This is because the dental and vision plans cannot be aggregated with either core plan I or II and still have such plans treated as qualified core health plans. If participating in core plan I, the highly compensated employee can receive a tax-preferred benefit of $665 (1.33 x 500). If participating in core plan II only, which is not a qualified core health plan, the taxable benefit for a highly compensated employee is $435 ($1,100 - $665). Participation in either the dental or vision plan by a highly compensated employee who participates in core plan II, cannot be on a tax-favored basis, even though the benefits are available to all employees on a similar basis. Accordingly, a highly compensated employee participating in core plan II, the dental plan and the vision plan would have a total employer provided benefit of $1,400 ($1,100 + $200 + $100) of which $735 ($1,400 - $665) would be taxable.

The excludable employees should not be affected by plan coverage

In determining whether 90 percent of employees are eligible for coverage, it is important that the employer accurately count his total employee population. Certain categories of employees can be excludable, but only if no employee in that category is included in the health plan. This complicates the testing process and penalizes employers for allowing certain employees to participate. For example, assume an employer offered health benefits to employees working 10 hours or more in prior years. When this employer changed health benefit eligibility to employees working more than 25 hours per week, the continuing employees working fewer than 25 hours and more than 10 hours were allowed to remain in the plan. These employers are now penalized by being required, in calculating the 90 percent test, to include in the employee group all employees working more than 10 hours per week.

Another situation with inappropriate results occurs when the employer provides immediate coverage for all employees or for some part-time employees, perhaps because they are classified as permanent. For example, an employer may offer health coverage to all employees at the beginning of employment. The employee is classified as part-time or full-time based on actual hours worked during the first three months of employment. If the employee is a part-time employee, coverage is eliminated. This employer is penalized because all employees are included in the employee population. The exclusion for part-time employees is not available since part-time employees are provided benefits for three months. Here, an employer who offers more health benefit coverage than required is being penalized by expansion of the group of employees tested.

Under existing rules, IRC section 89(h)(5) allows the employer to separately test employees receiving benefits who otherwise were excludable employees. This has been eliminated in the proposed legislation. If the excludable employees can be tested separately, the plans would be nondiscriminatory. This separate testing rule mitigates the harsh effect of requiring such employees to be included in the employee group.

The AICPA favors elimination of the rules which require adjustment of the excludable group based on plan coverage. At a minimum, inclusion of the separate testing rule in the legislation is needed.

Good faith compliance with separate line of business rules

The bill allows these rules to be applied on a separate line of business or operating unit basis. We recommend that the legislation make it clear that a good faith attempt to comply with such rules is sufficient until after the publication of final regulations. Final regulations should only be effective after issuance.

Existing law modifications should conform

Under the bill, employers who use existing section 89 for 1989 testing may not use any of the bill's improvements, such as the 25-hour rule for determining part-time employees. This is an especially harsh result for those employers. If an employer uses the new rules, he has the advantage of being able to use the more liberal part-time employee rules. However, the employer who uses the old rules is at a disadvantage. These employers should be given the same advantage as the employer who uses the new rules.

Valuation rules need clarification

The bill provides that the value of coverage provided by any health plan should be determined under procedures prescribed by the Secretary. TAMRA provides special transitional rules for testing years beginning before the later of January 1, 1991 or the date one year after the Secretary of the Treasury first issues such valuation rules as are necessary to apply the provisions of section 89. The bill should include the special transitional relief available in TAMRA.

Discriminatory terms test adversely affects accidental death and dismemberment

Accidental death and dismemberment insurance plans and business travel accident insurance plans will most likely fail the discriminatory terms test. The benefits payable under such plans are generally based on an employee's compensation. These plans should be excluded from testing under section 89. The value of such plans is de minimis in relation to the effort to properly include such amounts on an employee's W-2. Alternatively, the legislation could provide that such plans are not in violation of the discriminatory terms test if benefits vary as a uniform percentage of compensation.

Dependent care assistance discrimination test is too harsh

Existing law allows dependent care assistance to pass a 55 percent benefits test or be included in the section 89 test with health benefits. The proposed legislation would eliminate the ability to test dependent care assistance with health benefits.

The separate line of business rules also do not apply to these tests. We recommend that the dependent care assistance rules be reviewed. Inclusion of a separate benefits test for all nontaxable benefits in a cafeteria plan may satisfy this concern because most dependent care assistance, other than employer owned facilities, is offered on a salary reduction basis.

The exclusive benefit rule should allow nonemployees in an employer's plan

We believe that section 89(k)(1)(D) should be amended to allow a de minimis number of individuals with no service nexus with the employer to participate in a plan without violating the exclusive benefit rule.

According to the legislative history of section 89, Congress believed that the cost of allowing an employer deduction for health benefits was justified if the important social policy objective of increasing health insurance coverage was met. Thus, section 89(k) was designed to broaden, not restrict, coverage. According to the General Explanation of the Tax Reform Act of 1986 prepared by the staff of the Joint Committee on Taxation, "Congress did not intend that a plan fail to satisfy the exclusive benefit rule merely because benefits are provided under the plan to non-employees on a basis that is not tax favored." The intent in implementing the exclusive benefit provision of section 89(k)(1)(D) was not to restrict coverage of non-employee plan participants to only those who perform significant services. However, this is required in the proposed regulations.

The floor statement to this proposed legislation addressed the exclusive benefit requirement of current law by providing that, "this exclusive benefit requirement is satisfied if the number of individuals with no service nexus to the employer who participate in the plan is de minimis." We believe H.R. 1864 should make the rule clear for all future years. We understand that proposed regulations generally do not become effective until 1990.

Allowing individuals with no service nexus into an employer's plan on a non tax-favored basis does not violate the social policy behind section 89. Including such individuals will actually increase health insurance coverage. The only problems caused by including such individuals could be with adverse selection against insurance companies. Thus, the ability for an employer to include such individuals should be regulated by the insurance industry and their contracts with an employer, not through the tax law.

Qualification rules in general

The purpose of the qualification rules is to ensure that employees receiving a tax preference for certain benefits are actually receiving those benefits and not cash. We believe that these rules should conform with existing ERISA rules to ease administration for the employer.

The effective date of existing law should be delayed

While we are aware that the proposed regulations offer a number of transitional rules and delayed effective dates, we believe that these should be incorporated in H.R. 1864. Depending on the timing of legislative action on IRC section 89, a further delay may be necessary. Such delay should be statutory.

CONCLUSION

In view of the burdens placed on practitioners and businesses by section 89, legislative relief is needed. Given that the cost of compliance was the AICPA's most significant concern, we congratulate the Chairman on a proposal which saves compliance dollars by focusing on plan availability rather than coverage. The AICPA will be pleased to continue working with the committee to accomplish its objectives.

Mr. **Levin**. Thank you very much.

Mr. Hansen.

As you heard, there is a vote on, but we are going to try to keep going here.

Mr. Hansen, welcome. Why don't you proceed?

STATEMENT OF KARL E. HANSEN, CHAIRMAN, TASK FORCE ON HEALTH INSURANCE, FEDERAL LAW AND LEGISLATION COMMITTEE, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, AND PRESIDENT, VITA INSURANCE ASSOCIATES, MOUNTAIN VIEW, CA

Mr. **Hansen**. Thank you, Mr. Chairman.

My name is Karl Hansen. I am here representing the 135,000 members of the some 900 local associations that are members of the National Association of Life Underwriters Federation. NALU's conference, the Association for Advanced Life Underwriting joins in the statement. Currently, I hold the position of chairman of the NALU Task Force on Health Insurance. Professionally, I am a group life and health insurance broker doing business in the San Francisco Bay area. My firm provides services to employer groups ranging in size from 2 to 2,000 employees, with the majority of our 300 accounts employing 5 to 100 employees, relatively small employer groups.

Like many of my colleagues, we have been preparing to assist our clientele in the compliance efforts necessitated by section 89. Unfortunately, the underlying social, tax policy, and revenue needs that created section 89 have proved to be extremely cumbersome in the real life world of employee benefits administration.

With that statement of fact, we applaud the efforts of the chairman and this committee to simplify and reform section 89. It is clear that the current law was created with the intent to be both comprehensive and fair, especially to employees of large, diversified businesses.

We feel that the design-based plan which is both available and affordable, and which is the cornerstone of H.R. 1864 would solve the need for simplification of section 89. In short, with the addition of some important modifications, we at NALU fully support your effort.

Our recommended modifications are presented here this afternoon with the intent of reflecting further needs of the actual employer situations that exist in the market today. Specifically, the current dollar amount affordability standard is potentially too rigid and does not properly reflect demographic and geographic realities. Additionally, in conjunction with the design-based approach, we would recommend an affordability standard which would be based on a percentage of employee compensation and/or a percentage of premium.

Second, while we do support the concept of a design-based approach—although we may deviate a little bit from the exact approval in H.R. 1864—we realize that oversimplification can cause plan flexibility to be severely sacrificed. Because of this, we would ask you to offer your simplified approach as an option to the existing coverage-based approach, rather than as the only alternative available.

Thus, through this process, you allow employers to choose to comply with the existing although simplified testing requirements. This will present yet another opportunity, that being an incentive to provide coverage to more part-time employees. Such an incentive can be derived by allowing employers a leveraging provision to the benefits provided to part timers. Thus, instead of the current equalizing benefit factors available for part-time employees, we would propose that the part-time factors be moderately increased to reward those employers who do, in fact, cover such part-time individuals.

Finally, we would like to propose some brief definitional modifications. First, we believe independent contractors, when covered, should be able to be tested as a separate line of business. Second, we feel that formal retirement coverage should be differentiated and tested separately from coverage available to former employees on a general basis. Third, we feel that the accidental death and dismemberment coverage, because it typically mimics group term life insurance benefits, should be tested under the nondiscrimination rules of section 89. Finally, to avoid one of the greatest dilemmas facing all employers, we would ask that every effort be made to incorporate a single day data-gathering and testing approach whenever possible.

NALU supports your efforts to simplify section 89. We are, however, mindful of the potential cost of such reform. We hope that any proposed safe harbor approach reflect a plan design that would have typically passed the existing original testing parameters.

We feel that our part-time leveraging approach, assuming that it is cost effective, may, in fact, provide coverage that would enhance one of the original objectives of section 89; that is, to increase the scope of coverage to all workers, both full time and part time.

In conclusion, we again reiterate our support of your simplification efforts and will continue to be available to you and your staff as this process moves forward. I invite the opportunity to answer questions and thank you for the time.

[The statement of Mr. Hansen follows:]

TESTIMONY OF
THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Thank you, Mr. Chairman, members of the Committee. I am Karl Hansen, an insurance broker who lives and works in Mountain View, California. I am here today representing the National Association of Life Underwriters (NALU). NALU is a federation of state and local associations and represents those associations on matters of importance to them and the 135,000 sales professionals in life and health insurance and other related financial services who are members of those local associations. I am chairman of NALU's Federal Law and Legislation Committee's Task Force on Health Insurance.

As a health insurance broker, I daily work with employers who are providing group health insurance to their employees. My company has more than 300 employer clients, most with employee groups of 50-100 employees. I have had to learn as much as possible about the requirements and purposes of §89 in order to advise my clients on how to comply with §89's rules, and, where necessary, how to modify their plans so that they are nondiscriminatory as defined in §89. Thus, I -- and many thousands of my colleagues -- have first-hand experience with trying to tailor market-driven group health plans to a set of statutory rules that reflect social, tax policy and revenue needs to a far greater extent than they accommodate the real-world group health insurance market, in all its variations, around the country.

Let me begin by expressing my own and NALU's appreciation for your effort to reform §89. It is clear that much of the complexity in current law and proposed regulation stems from a laudable effort to be fair, especially with respect to highly-compensated employees of large, diverse businesses. However, it is equally clear that there is an overriding need for a discrimination test that is simple, one that eliminates the need for the burdensome data tracking required by current law's actual coverage-based tests. We believe that the design-based affordable availability test that is the cornerstone of H.R.1864 would solve this need for simplicity, although we will offer for your consideration changes to the testing standards that we believe will improve their usefulness to smaller and less complex group health plans. In short, with the addition of some important modifications we fully support your effort.

DOLLAR-AMOUNT AFFORDABILITY STANDARD IS TOO RIGID; PRODUCES UNEVEN IMPACT ON QUALITY OF AVAILABLE COVERAGE

Although NALU supports the concept of a design-based test as embodied in H.R.1864, we suggest that the rules would be more suited to the actual marketplace -- and just as effective at encouraging broad-based coverage -- if the affordability standard were modified. Currently, H.R.1864 would cap the premium to be paid by a non-highly compensated employee at $10/week for employee-only coverage and $25/week for the employee and his/her family coverage. Although these amounts are indexed to the minimum wage, they will not automatically adjust to changes in health care costs, and therefore, health insurance premiums. Thus, although the cap is now in most instances and in most areas within reasonable distance of actual costs and actual employer contributions, it is all too probable that rising costs and therefore premiums will make those dollar amounts unmanageably inadequate in the foreseeable future. If inadequate dollar-amount employee contributions drive employer costs unacceptably high, the result could be a serious decline in the level of employer-provided coverage.

Another serious problem with use of dollar amounts pegged to minimum wage as the standard for measuring affordable employee contributions is the fact that geographic and demographic variations around the country will make the impact of the cap fall unevenly on both employers and employees. For example, employers in above-average cost areas are likely to be paying more than minimum wage for jobs that would command only minimum wage in lower-cost areas. Plus, the cost of health care and health insurance is likely to be higher in the high-cost areas. Yet, the uniform $10 and $25/week caps cannot reflect these differences. The result could be lesser-quality plans being offered in high-cost areas, where many of the lower-paid employees could, as a result of comparatively higher wages, afford to contribute more for better quality coverage. Conversely, the employees in lower-cost areas might end up paying comparatively more for similar levels of coverage when geographic and demographic comparison factors are examined.

In addition, the single cap for "family coverage" cannot accommodate actual availability of different premium rates for different family structures. Many insurers are offering rates pegged to family size. For example, some plans offer one premium for employee plus spouse; another, higher rate for employee plus spouse plus children; and/or still other rates for employee plus children only or employee plus 1, 2 or 3 dependents. Again, the $25 cap could produce an uneven effect in terms of the quality of coverage available because of the cost associated with varying family size and structure.

AFFORDABILITY STANDARD SHOULD ALLOW FOR PERCENTAGE OF PREMIUM AND/OR EMPLOYEE COMPENSATION

The addition of an alternative affordability standard tied to percentage of compensation and/or to percentage of premium could solve many of the problems that could arise under a dollar amount cap. Although such a standard would be a bit more complicated than the dollar amounts, it would give employers a choice that could make a difference between offering a plan at all versus one that would be affordable to the employer, albeit at the cost of a minimum amount of complexity.

A percentage of the employee's compensation as an affordability standard allows more flexibility in financing without sacrificing much, if any, economic affordability. Further, because wages and prices tend to be related (i.e., high-cost areas tend to be higher-wage areas, too), the percentage of compensation standard would, to a degree, reflect the geographic and demographic variations that produce such an uneven impact on the dollar amount standard. If the test allowed the use of a percentage of premium as well, the problem of multiple rate structures would also be eased.

To illustrate, let's compare a group and how it would fare under several scenarios. Assume, please, a group of 50 employees in my home town, Mountain View, California. The Mountain View area is right in the middle in terms of high versus low cost. The group breaks down as follows:

5 employees who are highly compensated; all have a need for dependent coverage. Three need to

> insure their spouses and children; 1 will cover only a child and the 5th will insure only a spouse.
>
> 45 non-highly compensated employees, 5 of whom are earning minimum wage (40 hours/week at $3.65/hour, or $7,592/year). Of the 45, only 15 carry employee-only insurance; the remaining 30 need dependent coverage. Ten want spouse-only; 15 cover spouse plus children and 5 insure only one child.

Under the rules proposed in H.R.1864, the employer would have to make a core health plan available to at least 90% of the 50 employees (45). Since our fictitious group will cover all 50 employees, that test is met easily. Next, to be nondiscriminatory, the employer can charge its 50 employee-only insureds $10/week each, or $43.33/month ($10 multiplied by 52 divided by 12). The 35 employees who need dependent coverage can be charged $25/week each, or $108.33/month ($25 multiplied by 52 divided by 12).

Now let's look at what's available in the marketplace, at what price. First, the most typical employer payment for health insurance is either 50% of the total premium (employee plus dependent coverage), or 100% of the employee premium and a varying portion of the dependent coverage premium.

A major medical plan that includes a discount for use of participating health care providers (a "PPO" feature), maternity coverage, a $100 individual ($300 family) deductible and a 90/10 copayment feature for the first $500 of individual ($1,000 for family) expenses would cost per month about $131 per employee; $243 for employee plus spouse; $248 for employee and child; and $360 for employee, spouse and children. (Please bear in mind that lesser coverage -- for example, a plan with higher deductibles and/or copayments or fewer benefits would cost less. Conversely, eliminating the "PPO" feature or reducing the deductible or copayment would increase the cost.)

Thus, to meet the discrimination standards set out in H.R.1864, this employer would have to pay $87.67 for each of its 15 employee-only insureds; $134.67 for each of its 11 employee and spouse people; $261.67 for each of its 18 full family coverages; and $139.67 for each of its 6 employee and child beneficiaries. Thus, this employer is facing a total monthly premium cost of about $8,344.50 if its plan is to meet the discrimination tests set out in H.R.1864. This compares to $12,635 in total monthly premium for this group. Thus, to be nondiscriminatory under H.R.1864, this plan would require the employer to pay about 66% of its cost.

Let's compare this to percentage of compensation and percentage of premium standards. Assume for the sake of argument that an affordable percentage cap would approximate the percentage of the dollar amount cap to the minimum wage. Thus, at $10/week for employee coverage on a full-time (40 hour) minimum wage worker ($3.65/hour multiplied by 40 hours, or $7,592/year or $632.66/month), the percentage would be 6.8% of compensation for employee-only coverage. For dependent coverage, a $25/week contribution translates into about 20% of the full-time minimum wage worker's compensation.

To do an actual comparison to the hypothetical group described above would require making assumptions on each of the employee's compensation. To keep it simple, let us assume that of the 45 non-minimum wage workers, 20 earn $15,000/year; 20 earn $30,000/year and the 5 highly compensated earn $60,000/year. Under the percentage of compensation test the minimum wage workers' maximum contribution would remain at about $43/month for employee coverage and $108/month for dependent coverage. But the other 45 workers could be charged more. Thus, the employer would have the option of reducing the minimum wage worker's contribution by charging more to those who earn more; and, most importantly, would have some room to absorb rate increases due to improved coverage, inflation or a change in employee population that results in more dependent coverage costs. A similar analysis proves that a percentage of premium test could also provide flexibility without sacrificing low-income affordability.

For these reasons we encourage you to offer a choice among dollar amount, percentage of compensation and percentage of premium affordability standards. Such a choice could well produce the incentive to expand coverage rather than shrink it as economic conditions change.

DESIGN-BASED TEST EASES COMPLIANCE BURDEN; BUT FAIRNESS REQUIRES A FLEXIBLE, IF MORE COMPLICATED, ALTERNATIVE

The basis of H.R.1864 -- a design-based availability test that is simple to understand and to administer -- will alleviate many of the compliance problems inherent in the actual coverage tests that form the basis of current IRC §89 and its proposed regulation. The requirement that at least one plan be available and affordable to at least 90% of the employer's non-highly compensated employees is in fact a simple-to-understand, easy-to-administer concept. We support it. However, we would ask that you consider offering this test as an alternative to the more complicated actual coverage based test concept rather than as the only way an employer's highly compensated employees can receive tax-free group health insurance. Simplicity, for all its merits, also has some disadvantages, chief among them being little room to accommodate flexibility. In addition, the requirement that the core plan(s) be affordable as well as available raises difficult issues that can be fully and fairly resolved only by allowing an employer to choose between the simple design-based test and the more complicated actual coverage test concepts embodied in current IRC §89. Although the addition of percentage of compensation and/or premium testing standards help with the flexibility requirement, they do not allow the kind of creative, flexible planning that cost-conscious, larger employers require. The actual coverage tests -- the 90/50 test and 75% benefits test -- are particularly useful for computerized employers with trained benefits personnel and large low-to-medium-wage work forces.

Thus, while many -- perhaps most -- small employers will welcome a safe harbor that embodies the concepts contained in H.R.1864, the larger, more labor-intensive employers will likely benefit more from the more complicated actual coverage tests. Many have already invested time and money resources in learning current §89 requirements and making the plan changes needed to comply. For them, requiring adherence to an admittedly simple but also comparatively rigid design-based test would represent a hardship at least as burdensome as the complicated actual coverage based tests impose on the smaller employers.

INCENTIVE TO COVER PART-TIMERS POSSIBLE IN ACTUAL COVERAGE-BASED TESTS

One of the principal motivations behind enactment of §89 was a desire to expand employer-provided group health coverage, especially to low-paid and part-time employees. The economics of doing business argue against having to include half-time workers in discrimination testing calculations and for this reason NALU supports easing the part-time rule to 25 hours. However, we also support the provision of incentives to cover more workers. Therefore, we suggest that you consider adding an economic incentive to the actual coverage test part-time hours rules. As they are currently written the rules "count" 17½-25-hour workers as approximately equal value -- i.e., the ½-time worker is counted as if he/she received one-half of a full-time worker's benefits. This "conversion factor," if weighted to 2.5 (instead of the current 2) for 17½-hour workers (1.66 instead of 1.3 for 22½-hour workers), could provide an incentive to the employer to actually cover its part-time workers. This is because by doing so the employer could enrich the tax-free coverage it could provide to highly-compensated employees. Such an approach -- if not too costly in lost federal revenues -- could well turn out to be an efficient, effective way to expand health coverage of low-paid, part-time workers.

DEFINITIONAL MODIFICATIONS ARE NEEDED

For both design-based and actual-coverage-based tests some further definitional modifications are needed. We would like to focus on four specific needs.

First, there remains a real question about how to treat independent contractors for testing purposes. Although it makes sense to treat some independent contractors as if they were leased employees, in many cases the facts are different enough to warrant different treatment. One example is a sales force -- like some life insurance agents --that is made up exclusively of independent contractors. Such a group really is not comparable to the in-office employees of the company. Thus, we urge you to create a safe harbor for independent contractors that would allow employers to test them as a separate line of business.

Second, there is now and will be even more in the near future (due to pending accounting practices changes) a real difference in health plans that benefit active employees and COBRA-qualified beneficiaries as compared to retired employees who continue to receive employer-provided health insurance. Thus, we ask you to allow separate testing for former employees who are participating in a retiree health plan. Plans benefitting former employees, retired or not, who are COBRA beneficiaries should be tested together.

Third, the pending proposed §89 regulation specifies that accidental death and dismemberment (AD&D) benefits are governed by §105, and therefore would be subject to §89 discrimination rules under H.R.1864. However, the typical AD&D benefit -- which is a near-universal feature of group health plans -- is structured and priced like most §79 group term life insurance. Thus, it would be far more appropriate to test for discrimination in AD&D benefits under the discrimination rules of §79 rather than the §89 requirements. We urge you to specify this in the final §89 reform legislation.

Fourth, to the extent that testing is still required under the design-based concept in H.R.1864, there remains a need to specify that the testing can be carried out based on data in existence on one pre-selected, representative day of the plan year. Some testing will still need to be done, to determine whether highly compensated employees are receiving 133% or less of the value of the core health plan(s) in tax-free group health benefits. To avoid burdensome administrative requirements, the final legislation must approve the one-day testing concept.

A WORD OF CAUTION: COST COUNTS!

NALU supports your effort to simplify and rationalize the §89 antidiscrimination rules but, like you, we are mindful that there may -- probably will -- be a cost to the reform effort. To date, that cost has not been calculated for any of the reform proposals, nor have there been offered suggestions on how to pay that cost. Until we know the cost, and the source from which it will be paid, NALU's support for any specific §89 reform proposal must be contingent on identification of an acceptable financing mechanism.

SUMMARY: IF COST-EFFECTIVE, H.R.1864, AS MODIFIED, REPRESENTS SIGNIFICANT IMPROVEMENT

To the extent that the cost of §89 reform is acceptably financed, NALU supports what would be essentially a blend of H.R.1864 and S.654, as modified. In other words, we urge you to enact discrimination rules that offer a design-based test as a simple safe harbor, with affordability defined as either a dollar amount cap or a percentage of compensation and/or premium cap. We also encourage you to retain actual coverage based testing for those employers with flexibility needs that outweigh the cost of complying with complex but flexible rules, and to change the definitions of includible/excludible employees to accommodate the existence of independent contractor labor forces, to allow separate testing for retired employees who are covered by a retiree health plan, to use §79 discrimination standards for AD&D benefits, and to limit data-gathering for testing purposes ("one-day testing").

H.R.1864 DESERVES SUPPORT, THANKS

In closing, we would like to emphasize how good an effort we think H.R.1864 represents. It solves many of the problems inherent in current law §89 and goes a very long way towards creating workable discrimination rules for employer-provided group health insurance. We thank you Mr. Chairman and members of the Committee for your efforts to date, and for your willingness to consider our input. We will be glad to assist you and your staff in any way we can as this process moves forward. I'll be glad to try to answer any questions you may have now.

Thank you.

Mr. **Levin**. Thank you very much, Mr. Hansen.

Mrs. Johnson, do you have a question? You have not voted yet?

Mrs. **Johnson**. No, I have not voted yet.

Mr. **Levin**. Do you have a question before you and I need to leave to vote?

Mrs. **Johnson**. I have just a quick question.

Why does this discourage cafeteria plans? Why can't it be arranged in such a way that there is that flexibility within the standard?

Ms. **Walker**. I think the way the law is drafted now, cafeteria plans are just treated differently than other employer-provided benefits. The purpose, as stated in the legislative history, is that it is not a true employer-provided benefit; that when people reduce their salary they, in fact, give up something. Therefore, it cannot be considered part of the affordable plan piece.

Mrs. **Johnson**. Do you see any reason why it could not be drawn so that cafeteria plans would be permissible?

Ms. **Walker**. No. In fact, that may be preferable. Every time I try and design a way in which cafeteria plans would be permissible, I run right up against the problem which is that it is not truly an employer-provided benefit, that somebody is reducing their salary. If, in fact, that happens, we cannot count it as something given by the employer. It would be preferable within the same system. I just have my doubts that is possible.

Mrs. **Johnson**. That is a point that I have heard raised before, and I think clearly when we are looking toward Workforce 2000, we have to look toward the varying needs of our work force. And to write this in such a way that we discourage cafeteria plans at the very time we are debating day care subsidies is an irony that should not go unnoticed. And I would hope that we can write it in such a way as to retain that benefit.

Ms. **Walker**. I agree with you wholeheartedly.

Mr. **Levin**. Thank you. The committee will stand in recess. I think it will be only for 2 or 3 minutes. Some of my colleagues will be returning shortly on this shuttle that we run here. They will be back in just a minute or two.

We stand in recess.

[Recess.]

Mr. **Pickle** [presiding]. The Chair will ask the committee to come to order again. We are still in the middle of a vote, but we think the other members will be coming back. Because of the length of our witness list today, we thought we would continue.

As I understand it, all of the witnesses have made their statements. Has any witness not made a statement who wishes to say anything additional?

[No response.]

Mr. **Pickle**. We thank you. Before you leave, though, let me ask this. Before I left, one of you made some reference to the fact—I believe Mr. Klotz—that we ought to lower the 90-percent test down to 80 percent. Would not the same problem of a cliff exist at 80 percent as it does at 90 percent?

Mr. **Klotz**. Yes, it would if you approach the 80 percent in an absolute term. But, obviously, the extra 10 percent does give you additional flexibility, particularly in the area where you are having trouble with leased employees and part-time employees.

Mr. **Pickle**. Well, we give you some flexibility from going from 100 percent down to 90 percent. Now you want another 10 percent.

Mr. **Klotz**. Well, we like as much flexibility.

Mr. **Pickle**. Some of the rest of you want it down to 70 or 60 percent.

Mr. **Klotz**. We just think 80 percent is a reasonable approach, especially for very large employers that have many groups of employees around the country, many different plans, as has been explained before.

Mr. **Pickle**. Well, would it not be an equally desirable hope to believe that we might come up with some kind of a definition for the 90-percent test, some kind of a safety valve so there would not be just an automatic cutoff? Now, that may be a little difficult to put together, either by report language or by some specific qualification. But no matter what level we put it, we will have that same cliff problem.

Mr. **Klotz**. Yes.

Mr. **Pickle**. I think we have got to try to find some way to keep people from unfairly being penalized if they go down to 89.5 percent, because that would not be the intent. And yet we have got to have an arbitrary decision. So we will keep that in mind and see what we can find out.

Mr. **Klotz**. Thank you.

Mr. **Pickle**. Now, I noticed that some of the witnesses—I think maybe it was Ms. Walker, or somebody—stated that you advocated using the medical CPI index with regard to the premium limits rather than the wage level. I do not know who was making that recommendation, Mr. Klotz or some of the rest of you.

Mr. **Klotz**. We made that recommendation also.

Mr. **Hansen**. We would echo it.

Mr. **Pickle**. Well, either one of you. Now, why do you want the medical index used instead of the wages?

Mr. **Klotz**. The costs of medical expenses are going up much faster than the normal rate of inflation in this country. And if you continue to index the $10 and $25 to a Consumer Price Index, eventually you are going to have a higher and higher cost being borne by the company. We do not think that is a fair and equitable way to split medical costs. If you do it on the inflation factor in the price index, you then keep the $10 and $25 in line with what is really happening out there in the medical cost world.

Mr. **Pickle**. Well, then, your purpose is to set an indexing measurement that would increase the premiums?

Mr. **Klotz**. Yes.

Mr. **Pickle**. That is, in effect, what you are trying to do.

Mr. **Klotz**. The maximum amount of that allowable in 1864.

Mr. **Pickle**. Now, I would ask you, how much more would the increase be if you used the medical CPI index approach than it would if you used wages?

Mr. **Mueller**. The difference in the past few years, Congressman, has been 5½ versus anywhere from 13 to 22 percent. So there is marked difference between both indexes.

Mr. Pickle. Well, I am trying to find how would it be over a period of, let us say, 4 or 5 years. What would it amount to? How much of an increase would it be in premiums if you did use the medical CPI index?

Mr. Mueller. Well, over the 4- or 5-year period, it would be a 25-percent increase from the base period if you use wages; it would be more toward the 60 to 80 percent if you use the CPI index.

Mr. Pickle. More toward the what?

Mr. Mueller. The 50- to 60-percent index. If you use the CPI, the medical cost component of the CPI, it is more toward the 50 to 60 percent if you project forward.

Mr. Pickle. Well, someone had commented that it might be almost double the amount it is.

Mr. Mueller. Right.

Mr. Pickle. If so, then that is a consideration for us, is it not?

Mr. Mueller. That is correct.

Mr. Pickle. Well, what do each of you think, any of the panelists who have testified? What would be the cost of the bill H.R. 1864? Would it really reduce the cost of compliance, the bill that we have before us?

Mr. Mueller. I would like to start with that, Congressman, if I can. The Rostenkowski bill will reduce the cost of compliance. As we have stated in our testimony, there would be no longer a tracking of family status information, no more tracking of actual coverage of non- and highly-compensated people. However, we still have the problem with leased employees, former employees and marginal data requirements.

To give you an analogy, when section 401(k) came out a few years back, we spent about a nickel, 5 cents, per employee per month to administer that test. Section 89 as currently constituted will cost us anywhere from $1 to $2 per employee per month administratively. It is down from the current law, but still a far heavy requirement on business.

Mr. Pickle. Each of you panelists, I would ask, do you in general—I was not here for all the testimony—approve of the approach we are taking in the H.R. 1864, rather than the original bill, present law?

Mr. Klotz. Yes.

Mr. Mueller. Yes.

Ms. Walker. Clearly.

Mr. Pickle. Everybody agrees it is the better approach?

Mr. Hansen. We absolutely agree. The one point that I think is coming out here, though, is that a number of exceptions are going to be required in order to make H.R. 1864 workable. That is why we had recommended the proposition that, again, H.R. 1864 be looked at as a safe harbor, with the actual original law as simplfied being kept intact. This is because we are going to end up with all these exceptions that are going to fill just as many pages as the current law.

Mr. Pickle. Well, I think I am not incorrect in passing on what I think is the general view of the chairman of the committee, that this bill is intended to be an answer to the present law, and it is not being presented as a starting point for you to add every, quote, cat and dog amendment that comes along, or any member that might weaken it. I do not think we are going to see the committee retreating from its nondiscrimination principles.

I think this is a much better approach, and I hope that we can take your views into consideration. I am sure we will. So I thank each one of you for your testimony. Thank you very much.

Our next panel will consist of Robert Larsen; Kathi Child, accompanied by Julie Hansen; John Satagaj; and Alice B. Griffin.

Our first witness will be Robert Larsen, who represents the National Association of Wholesaler-Distributors; then Kathi Child and Julie Hansen, representing the Retail Tax Committee of Common Interest; followed by John Satagaj, president of the Small Business Legislative Council; and then to conclude our panel will be Alice Griffin, representing the National Small Business United.

So, Mr. Larsen, if you will, proceed first.

STATEMENT OF ROBERT L. LARSEN, PRESIDENT, INSURANCE ADMINISTRATION CENTER, PARK RIDGE, IL, AND INSURANCE ADMINISTRATOR, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Mr. Larsen. Thank you, Mr. Chairman.

Mr. Chairman, my name is Robert Larsen. I am president of Insurance Administration Center in Park Ridge, IL, and the administrator of insurance programs for the National Association of Wholesaler-Distributors on whose behalf I appear today. With your permission, I would ask you to include my prepared remarks in the record.

Mr. Pickle. They will be included, as will all the statements of the members of the panel.

Mr. Larsen. Thank you, sir.

We congratulate you and the other cosponsors of H.R. 1864 for your recognition that section 89 as now written contains impossibly complex requirements. By introducing H.R. 1864, you have created an opportunity, as sufficient time now exists, for this committee and affected employers to work together to craft simplified yet effective legislation which incorporates the objectives of section 89. This is both recognized and very much appreciated.

We do not disagree in any way with the underlying purpose of section 89, particularly when taken and viewed in the context of the Tax Reform Act of 1986. Employee financial security is essential to maintaining a stable and productive work force. Life, health, disability, and retirement plans are commonly provided to employees of NAW member firms with this in mind.

The principal complaint from NAW members, large and small, about section 89 is that substantial amounts of time and money are necessary just to assess its applicability, much less confirm compliance. Many of our members have indicated that they were contemplating elimination of existing health and welfare plans rather than go through the high initial and ongoing expense of testing for nondiscrimination. Others who were considering expansion of their employee benefit program decided against it once advised that this would result in greater costs due to the complexity of section 89.

Many accounting and consulting firms have advised clients that it would be simpler to pay employees the value of their benefits rather than continue to maintain plans. While this may be positive from a Federal revenue point of view, it is counterpoint to encouraging private coverage to ensure sufficient benefits for employees. This is because employees, especially lower paid ones, may well spend additional income of that type instead of using it to obtain health and other important coverages on an individual basis.

H.R. 1864 is an extremely positive legislative proposal. We do, however, have a few specific suggestions on some of its provisions. First, instead of the weekly $10 single, $25 family employee contribution ceiling, we recommend that firms be allowed to utilize a uniform percentage of cost contribution for all employees or, in the alternative, a flat dollar amount paid by the employer for all employees. If a flat dollar amount is employed, it should be indexed using a medical price index, as was suggested previously, rather than the SSA average weekly wage index, since this would more accurately track the cost of health care services.

Second, we would like very much your consideration to defining part-time employees as those working less than 30 hours per week rather than the proposed 25. This would parallel more closely the language in most existing group health insurance policies.

Third, we urge you to clearly define what constitutes a core health plan. The more Congress leaves to interpretation by the Treasury Department, the more likely it is that Congress will later say: That was not our intent.

We note with appreciation Secretary Brady's decision to postpone implementation of section 89 until October 1. This is a very constructive step, but we would urge that the effective date of section 89 be set as the latter of some future date or 6 months following promulgation of final regulations under H.R. 1864.

The wholesale-distribution industry and its consultants have been grappling with section 89's uncertainties for almost a year. Seminars, workshops, manuals, data systems, and hours and hours of analysis still leave the majority of employers uncertain as to how to comply with section 89. Therefore, we applaud your efforts, Mr. Chairman and this committee, to respond to this reality by proposing H.R. 1864.

We appreciate the opportunity to share our views today and look forward to working with you as the process of section 89 simplification proceeds.

[The statement of Mr. Larsen follows:]

STATEMENT OF

ROBERT L. LARSEN, INSURANCE ADMINISTRATOR, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

BEFORE THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES

ON

H.R. 1864 -- SIMPLIFICATION OF SECTION 89 OF THE INTERNAL REVENUE CODE

MAY 2, 1989

I. INTRODUCTION

My name is Robert L. Larsen. I am President of the Insurance Administration Çenter in Park Ridge, Illinois, and the administrator of insurance programs for the National Association of Wholesaler-Distributors, on whose behalf I appear today.

II. NAW AND THE WHOLESALE-DISTRIBUTION INDUSTRY

NAW is a federation of 117 national and 52 state and regional trade associations representing wholesaler-distributors of virtually every product in the American market. All told, NAW's membership covers some 45,000 companies with 150,000 places of business. These firms range in size from wholesaler-distributors with less than $1 million in annual sales to those with $13 billion. The typical firm has approximately $5 million in sales and employs 30 individuals.

Wholesale distribution is a labor-intensive industry. As a result, employee benefits constitute a significant portion of the wholesaler-distributor's cost of doing business. Therefore, enactment of Section 89 of the Internal Revenue Code was of great interest and concern to NAW's members.

III. NAW COMMENDS INTRODUCTION OF H.R. 1864

I would like to say at the outset that NAW strongly applauds Chairman Rostenkowski and the co-sponsors for their introduction of H.R. 1864. The legislation represents a major departure from the current law's impossibly complex requirements. Given the position of Congress as reflected in the language and legislative history of the Tax Reform Act of 1986 that tax-favored benefit plans should not disproportionately benefit highly compensated employees, NAW believes that the simplified testing requirements contained in H.R. 1864 will make it possible for wholesaler-distributors to assure the non-discrimination in an easier, more practical manner. Quite the opposite is the case today. The current tests are ludicrously complex to the point of being unadministerable. The smaller businesses among NAW's membership are finding it virtually impossible to administer the current tests. Larger members are also encountering substantial difficulties. For both large and small, the costs of compliance are totally out of kilter relative to carrying out the underlying purpose of Section 89.

NAW does not disagree with the underlying intent of Section 89, particularly when taken in light of the context of the Tax Reform Act of 1986. Moreover, our members believe that employee financial security is essential to a productive workforce. Life, health, disability and retirement plans are widely provided by NAW's members to their employees with this objective in mind. Fairness, balance, non-discrimination and fulfillment of promises should be central, not ancillary, to management's design and operation of fringe benefit programs. In my thirty-one years in employee benefit planning, consensus on these benefit plan attributes has been manifest among the wholesaler-distributors which we serve.

IV. WHOLESALER-DISTRIBUTORS' PROBLEMS WITH CURRENT LAW

If Section 89 has a laudable purpose, it has gone seriously awry in its implementation. My analysis, and that of most benefit professionals, is that Section 89 requirements are overwhelmingly complicated. Gratefully, you, Mr. Chairman, and the co-sponsors of H.R. 1864 share that view. And, to the point of being counterproductive, as with some aspects of ERISA, COBRA, and certain pension measures, the complexity of of Section 89 has been unnecessarily compounded by those responsible for promulgating regulations.

In an effort to play a constructive role in bringing about simplified Section 89 requirements, NAW solicited the views of its members on the specific practical problems they were experiencing in running the non-discrimination tests and complying with other provisions of Section 89.

The principal complaint, from large and small companies alike, was that substantial amounts of time and money are necessary to assess the methodology/applicability of Section 89, much less whether or not they were in compliance.

Many wholesaler-distributors indicated that they were contemplating eliminating existing health and welfare plans altogether, rather than go through the high initial and ongoing expense of testing for non-discrimination. Others considering adding employee plans benefits decided against such action because of the Section 89 requirements.

Many accounting and consulting firms have advised clients that it would be simpler to pay employees the value of their benefits rather than continue to maintain plans. While this may be "positive" from a Federal revenue point of view, it is counterpoint to a broader view which encourages private coverage to ensure sufficient health, disability and retirement benefits for employees. This is because employees, especially lower paid ones, may well spend this additional income instead of using it to obtain health and other important coverages on an individual basis.

We estimate that the majority of NAW's members will not experience problems complying with the qualification requirements. Indeed, the majority of companies already had in place a written plan available to their workforces. However, the requirement that employees' rights under a plan be "legally enforceable" raises some questions. For example, some companies were unclear about the full scope of legally enforceable rights in terms of an employee's right to sue for what he or she considers to be a breach of "rights."

The problems I have cited are being experienced by larger as well as smaller firms. Many of the larger firms were able to assess Section 89 in-house and expect to be able to pass the tests, but at considerable expense. Also, there seemed to be almost total confusion concerning how to test "multi-employer" plans and over the definition of "separate lines of business" among larger firms.

The average cost for small wholesaler-distributors -- most of whom have employed outside consultants -- has been several thousands of dollars to determine their basic responsibilities under Section 89. The streamlined approach to Section 89 testing as contained in H.R. 1864 will go a long way in saving companies from expending thousands of tax-deductible dollars simply to determine that their plans are not discriminatory.

V. SPECIFIC COMMENTS ON H.R. 1864

One concern expressed by wholesaler-distributors, which is addressed by H.R. 1864, is the definition of part-time employees. The current law's definition of 17.5 hours per week is much too low. The new definition of 25 hours per week contained in the bill is a constructive change.

The proposed repeal of the provision providing for the taxation of the value of benefits to all employees regardless of income if the employer is not in compliance with the qualification rules is one of the most important elements of H.R. 1864. Clearly, the approach contained in current law is extremely onerous. It is unfair to employees to penalize them for mistakes inadvertently made by their employers. Additionally, we believe that the current law's penalties will lead to a flood of litigation putting industry further at risk.

Another area which is burdensome to wholesaler-distributors and which is ameliorated through H.R. 1864 is the current law's requirement that employers must collect extensive data on employees' marital status and outside health coverage in order to determine whether or not to include them in Section 89 testing. H.R. 1864 simplifies this task by requiring that if core health coverage is available to 90 percent of employees within certain parameters, an employer can avoid non-discrimination testing This requirement will minimize the excessive recordkeeping and data collection requirements contained in current law.

NAW also endorses the elimination of the requirement that life insurance coverage be tested. Current law sufficiently ensures fairness and further testing is unnecessary.

VI. SUGGESTIONS FOR FURTHER IMPROVEMENTS TO SECTION 89

That being said, Mr. Chairman, we do have a few specific suggestions as to how Section 89 can and should be improved. They are as follows:

- Setting a $10 per week -- $25 per week for family coverage -- cap on employee contributions for health plans falls short of the mark in terms of today's health insurance costs. It seems both fair and flexible to simply permit a uniform percentage of cost contribution by employees or, in the alternative, a flat dollar amount for all employees. This would allow for plan variables adjusted to the geographic and financial capabilities of one employer versus another.
- The indexing of employee contribution limits would be more appropriate if tied to the medical price index, which, as you know, far exceeds the SSA average wage index.
- Part-time employees should be defined as those working thirty hours or less per week rather than twenty-five. This would be consistent with the majority of existing insurance contracts.
- The definition of what constitutes a core health plan needs to be further explained. This will avoid later, perhaps more expansive, definitions by the IRS.
- The effective date for compliance should be the latter of January 1, 1990, or six months following the promulgation of regulations. This would eliminate the present confusion of employers who are struggling to meet the requirements with incomplete guidance from the IRS.

VII. CONCLUSION

In conclusion, Mr. Chairman, I again thank you for the opportunity to present NAW's views. We again commend you and your co-sponsors for introducing H.R. 1864. In doing so, you have created an opportunity where sufficient time exists for the Committee and those who will administer compliance in companies to work together to carefully draft clear and simple, yet effective, compliance mechanisms. We very much appreciate this opportunity and look forward to working with you and the Committee as the process goes forward.

Mr. Pickle. Thank you, Mr. Larsen.

Now, who will testify next? Will it be Kathi Child?

Ms. Child. That is right.

Mr. Pickle. All right. You are recognized, Ms. Child.

STATEMENT OF KATHI CHILD, MANAGER OF BENEFITS DEVELOPMENT, J.C. PENNEY CO., INC., ON BEHALF OF THE RETAIL TAX COMMITTEE OF COMMON INTEREST, ACCOMPANIED BY JULIE HANSEN, TAX ATTORNEY, SEARS, ROEBUCK & CO.

Ms. Child. I am Kathi Child, manager of benefits development for the J.C. Penney Co. I am accompanied today by Julie Hansen, who is a tax attorney for Sears, Roebuck & Co. I will summarize the longer written statement which is being submitted for the record on behalf of the Penney Co. and seven other general merchandise retailing companies which are members of the Retail Tax Committee of Common Interest.

Mr. Chairman, the Retail Tax Committee members are pleased to express our strong support for both the general direction of H.R. 1864 and specific substantive provisions which dramatically revise and simplify section 89. It is our hope that H.R. 1864 will serve as the base on which a revised section 89 will be drafted and enacted this year.

We commend the design-based concept of the proposal. This approach is much less complex and administratively burdensome, and it addresses complaints put forth by all interested parties.

We also want to express our support for the legislative process which is under way. There has been extensive discourse between Members of Congress, the technical staffs, and the private sector. The introduction of H.R. 1864 has taken the process one significant step further by giving employers something specific to comment upon before concepts are converted into law. We recognize that this opportunity to review statutory language and to identify problems imposes on us an obligation to participate with responsible recommendations. Overall, we have preferred this approach of seeking substantial revisions and simplifications in section 89 to that of supporting total repeal.

To provide a context for three proposals which we urge be adopted, a few comments on our industry's work force are needed. The larger RTC members employ 300,000 to 500,000 people during a normal year. Some 50 to 60 percent of our employees work part time, meaning that they work less than 40 hours per week. Most of these part-timers are second wage earners in a household, "moonlighters," students, and retirees who look to other employers, not to the retailing companies, for health care benefits.

Furthermore, new employee turnover is very high in our industry. A new employee in retailing is much more likely to leave the job during the first several months than is an employee in other industries.

These facts present retailing management with serious problems. Full-time employees are eligible for health care plans of RTC companies, but they may comprise as little as 25 percent of the total work force. To offer coverage to part-time workers who either are likely to leave within a few months or will work relatively few hours during the week or will work only at certain seasons of the year and are almost certain to have coverage from another employer would be an extremely expensive and burdensome proposition which generally serves no business or public policy purpose.

Given these facts, a 90-percent eligibility test poses the principal problem for the RTC companies, primarily because of the definition of the base of employees to which current and proposed section 89 must be applied.

H.R. 1864 would make a significant improvement in this area by raising the standard for determining excludable part-time employees to 25 hours, which is much more in line with realities faced by our companies.

However, there are three other matters which we urge be addressed with respect to the 90-percent test.

First, the exclusion for certain groups of employees—namely, part-timers, those who do not yet have 6 months of service, those under 21, and seasonal employees—should not be denied simply because one employee in such a category is eligible under a plan. This is particularly the case with respect to part-time employees who are eligible because they have become members of a company's permanent work force. Similar situations arise with respect to employees in the other excludable categories.

Our second recommendation concerns the rule under current section 89 which allows these excludable categories to be separately tested to determine their compliance, in lieu of the complete denial of the exclusion. We understand that this separate testing rule was enacted to mitigate the harshness of the all-or-nothing exclusion, and we urge that it be retained.

Third, we recommend two options for mitigating the severity of the 90-percent test. The simplest approach is to lower the eligibility threshold to something in the 70- to 80-percent range. There are precedents for these percentages in the pension areas and in the proposed regulations for the current section 89.

However, any fixed threshold presents a cliff effect with respect to the tax penalty imposed on highly compensated employees. An alternative is to lower the threshold and use a simple sliding scale for the exclusion. For example, if 70 percent were to be the threshold for allowing any exclusion at all, then such exclusion could range from 100 percent of the nonhighly compensated employees' benefit when the plan reaches 70-percent eligibility up to the maximum 133-percent exclusion when the plan reaches the 90-percent threshold.

In summary, Mr. Chairman, the RTC companies commend you and this committee for both the substance of H.R. 1864 and the process by which it is being considered. We urge that the technical adjustments which we have recommended be included in the final version of the bill. We look forward to working with the committee in the development of a desirable substitute for current section 89.

[The statement of Ms. Child follows:]

STATEMENT OF

KATHI CHILD

ON BEHALF OF

THE RETAIL TAX COMMITTEE OF COMMON INTEREST

SUBMITTED TO

THE COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

"H.R. 1864 -- Revisions to Section 89"

May 2, 1989

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Introduction and Overview

I am Kathi Child, Manager of Benefits Development for the J.C. Penney Company, Inc. I am presenting this statement on behalf of the Penney Company and seven other general merchandise retailing companies which are members of the Retail Tax Committee of Common Interest (the RTC). The RTC companies have worked cooperatively on federal tax policy issues of mutual interest for approximately ten years. In addition to the Penney Company, the members of the RTC include BATUS Retail Division, Carson Pirie Scott & Company, Carter Hawley Hale Stores, Inc., Federated Department Stores, Inc., R.H. Macy & Company, Inc., The May Department Stores Company, and Sears Roebuck and Company.

The Retail Tax Committee members are pleased to express our strong support for both the general direction of H.R 1864 and its specific substantive proposals which dramatically revise and simplify section 89 of the Internal Revenue Code. This legislative proposal to replace current section 89 with an altered and streamlined section 89 for health care plans is a very significant contribution to resolving a contentious issue. It is our hope that H.R. 1864 will serve as the base on which a revised section 89 will be drafted and enacted this year in order to get this controversy behind all of us. We are pleased to be a part of this process, and we look forward to the development of a final bill which will address the larger issues that have made section 89 so controversial and will resolve additional technical problems with the section 89 rules.

As part of this process, we are presenting three proposals which we urge be included in the 90 percent eligibility requirement which is part of the simplified structure of proposed new section 89. They include (i) enacting a "true exclusion" for various categories of excludable employees (such as part-time employees, those under 21 and those with less than six months of service); (ii) retaining the separate testing rule for excludable categories allowed under current section 89(h)(5); and (iii) reducing the 90 percent threshold and/or eliminating the "cliff effect" of failing to reach that threshold. Other matters are presented in a more detailed technical appendix which is attached to this statement.

I. The Legislative Process

Before discussing the problems under current section 89 and the specifics of H.R. 1864, I want to express the appreciation of the RTC member companies' tax and benefits managers for the process through which revisions to section 89 are being addressed.

To date, there has been extensive discourse between members of Congress, the technical staffs and the private sector concerning both the problems which company executives have identified and the objectives which the Congress considers important. Our company representatives found a receptivity to our concerns by this Committee and your staffs which suggested that there was a possibility of revising some of the features of section 89 which have caused us the most trouble. Therefore, we have preferred the approach of seeking substantial revisions and simplifications in section 89 to that of supporting total repeal.

The introduction of H.R. 1864 has taken this legislative process one significant step further by giving benefits and tax managers something specific to study and comment upon before new concepts are converted into law. Benefits administration for an employer like the Penney Company -- which has 400,000 people employed at various times during the year -- is a very complex matter. The chance to assess the implications of a proposal, to identify potential problems and to recommend changes is very important. The text of H.R. 1864 gives me and my counterparts at other RTC companies -- as well as all concerned employers -- just such an opportunity to evaluate and comment on precise statutory language.

I understand from my tax and government relations colleagues that the pace of tax legislative activities has not often allowed this process to occur in the 1980s, including in the period leading up to the enactment of the Tax Reform Act of 1986, which included the original version of section 89. But whatever the pressures of the past have been, we appreciate the approach being taken with respect to revising section 89 this year. We view the introduction of H.R. 1864 as presenting us with both an opportunity to assess the substance of that bill and an obligation to participate in the process with responsible recommendations.

II. The Historical Perspective of RTC Companies

RTC executives recognize that section 89, as originally enacted in the Tax Reform Act of 1986, resulted from the related proposal by President Reagan in his tax reform package in May of 1985. The nondiscrimination rules replaced an earlier proposal, submitted in the "Treasury I" proposal of November, 1984, suggesting that statutory fringe benefits be taxed across the board. The purpose of the 1985 proposal was to promote broad nondiscriminatory employee benefits coverage and to provide uniformity in nondiscrimination testing.

The provision was adopted in the 1986 Act and subsequently amended in the Technical and Miscellaneous Revenue Act of 1988 in response to comments from the business community, health care providers and other interested parties. Lengthy proposed regulations were released on March 2, 1989.

Given the morass of issues facing taxpayers who were following the 1986 reform measure, many taxpayers -- including RTC companies -- did not give much attention to the nondiscriminatory benefits provisions. Yet, once the 1986 Act became law, more taxpayers began to take note of section 89 and to submit substantial comments. Unfortunately, most of the efforts to ease the problems identified by taxpayers involved the adoption of numerous exceptions and safe harbors in the Technical and Miscellaneous Revenue Act of 1988 and the proposed regulations, while still allowing for as much employer flexibility as possible in the provision. This has meant that current section 89 has become exceedingly complex.

Therefore, we commend the Chairman and members of the Committee for using H.R. 1864 to simplify section 89 by completely rewriting its provisions using what has come to be called the "design-based" or "plan design" concept. By proposing to replace the particularly complex and administratively burdensome mechanisms of current section 89, the bill addresses complaints put forth by all interested parties and presents a workable framework for drafting a new section 89.

III. Employment in the RTC Companies

The retailing industry's workforce is a substantial one. The larger RTC members have 300,000 to 500,000 people employed at various times during a normal year. All of our member companies have at least 35,000 employees on the payroll each year, which probably exceeds even the typical large manufacturers and other service sector employers. The benefits-related problems posed by such large numbers of employees might not appear to be substantial on the surface. By themselves, these numbers would not seem to require anything more than a proportional increase in administrative work to process benefits forms and perform other services which employers in other industries must perform with shorter payroll lists. But that assumes a relatively stable and full-time work force within the industry. In fact, the composition of the retailing work force -- at least as represented by the RTC member companies -- presents management with important business decisions when considering how to offer benefits such as health care plans.

Of these large numbers of total employees, some 50 to 60 percent are part-time employees (meaning that they work less than 40 hours per week). From surveys and other data sources, we know that virtually all of our part-time employees are in four general categories -- second wage earners in a household, "moonlighters," students and retirees. In these contexts, the part-time employee is not looking to the retailing company for health care benefits which would be available to a full-time employee. Instead, that person is covered either by the plan of the primary wage earner, of the full-time employer, of the parents or the former employer.

In addition to the high percentage of part-time employees, a percentage of the total payroll list in any given year is comprised of seasonal employees who are looking for work at selected times of the year. They may work only during holiday seasons when our demand is high or only during their vacation periods when they are looking for short-term work. Furthermore, the turnover of employees within their first few months for both full and part-time employees is substantial in this industry. A new employee is much more likely to leave the job during the first several months than is the employee who has been with a company for a year or more.

IV. Benefits Problems in the Retailing Industry

These facts present retailing management with serious problems. It is clear that full-time employees will be offered health care plans by RTC companies and others of similar size, because that is simply what is required to attract and hold a stable group of long-term employees today, whether full or part-time. But these employees may constitute as little as 25 percent of the names on a payroll during each year. To offer coverage to part-time employees who either (i) almost certainly have coverage from another employer, or (ii) are likely to leave within a few months, or (iii) will work relatively few hours per week, or (iv) will work only at certain seasons of the year would be an extremely burdensome and expensive proposition in terms of personnel administration costs. The problem is that such costs would be incurred for no business or public policy purpose because coverage is not wanted, needed or likely to contribute to the hiring of a permanent employee.

RTC member companies have long focused on what we have considered to be the principal objective of fair benefits packages, even before the enactment of section 89, namely the development of health care plans which offer nondiscriminatory benefits to the stable workforce upon which the companies must depend to remain in business. Our basic health care plans tend to have a high percentage contribution by the company -- 65 to 75 percent -- and all covered employees are provided the same employer-paid benefits.

V. Issues to be Addressed

In the context of the composition of the work forces of RTC companies and the generally nondiscriminatory nature of the health care plans provided by these companies, we offer the following comments on issues which are addressed in H.R. 1864 and three recommendations for revisions to that bill by this Committee.

A. The "Part-time" Employee

Given the disproportionately large number of part-time employees in the RTC companies' work forces, the exclusion of part-timers from the computations under section 89 has been our highest priority. We have been very concerned that current law allows the exclusion only of those who work far less than half-time -- i.e., less than 17½ hours per week -- rather than those who work part-time in the truest sense, meaning those who do not work approximately 40 hours per week.

The provision in H.R. 1864 which provides for an exclusion of employees who work less than 25 hours per week is the primary improvement which the bill would make to the substantive rules in current law, from our perspective. We believe that this brings the definition much more into line with the realities faced by our companies every day. To provide time for plans to be adjusted before the next plan year, we would urge that the number be placed at 30 hours for 1989, 27½ hours for 1990 and 25 hours thereafter.

B. 90 Percent Eligibility Requirement

One of the principal complicating features of current section 89 is the multitude of percentage tests for eligibility and benefits which the employer must meet to avoid the income tax sanctions for the highly compensated employees. It is ironic that the benefits tests which were thought to be the heart of the nondiscrimination concept -- i.e., the tests which require that the highly compensated not be offered employer-paid benefits which exceed various ratios when compared to the employer-paid benefits offered to the nonhighly compensated -- are passed by RTC companies generally. As noted above, our companies have long tended to offer plans which provide the same or very similar benefits to all covered employees. It is the 90 percent eligibility test which has posed the principal problem for RTC companies under current law, because defining the base of employees to which the 90 percent test must be applied is a troublesome task given the composition of our work forces.

The problem would continue in proposed section 89 under H.R. 1864 for two reasons. The absence of a "true exclusion" for the various categories of excludable employees is the principal cause of the problem. The deletion in H.R. 1864 of the separate testing rule in current section 89(h)(5) is the second.

While some arbitrary percentage number must be established, the 90 percent threshold is quite high, given these two definitional issues. With payroll lists which have large percentages of part-timers and seasonal employees and people who will not stay on the job longer than a few months, the 90 percent level is a very tough standard to meet unless the base of employees to which it is applied can be limited to a reasonable group. The impact of this threshold is made all the more harsh by the "cliff" effect which requires the highly compensated employees to include in income 100 percent of the employer-provided benefit if the plan fails to comply with the 90 percent eligibility test by even as little as one percentage point.

We urge that the Committee consider the following three recommendations with respect to the 90 percent eligibility test in proposed section 89. Two recommendations address the "base" of employees to which the 90 percent test is applied; the third addresses the percentage itself and the "cliff" effect.

1. True Exclusions for Employee Categories

The exclusions under current section 89 for certain groups of employees -- part-timers, those who have not completed six months of service, seasonal employees, those under 21 -- are denied if even one employee in that category is eligible for the plan. This means that any employee who works less than 25 hours a week or is under 21 or who has worked for less than six months but who is eligible for the health plan of a particular company forces the employer to include all such persons in the base to which the 90 percent eligibility test is applied. This result would be continued under proposed section 89 as well.

If there are discriminatory "games" which can be played with the exclusions -- particularly with the "six months service" category -- this problem should be addressed to the extent possible by the statute, by legislative history and by the resulting regulations. But the inclusion of all otherwise excludable employees due to the eligibility of a few seems to us to be too extreme a rule.

This is particularly the case with respect to part-time employees. RTC companies depend heavily on part-time employees whom we can count on as members of a permanent workforce. As noted earlier, it is important that this critical element of a stable workforce be treated as much like our permanent full-time workforce as possible. RTC companies may make the business judgment that part-time employees who clearly have become permanent employees should be treated like full-time employees to the extent possible. This can result in the eligibility of employees who normally work less than 25 hours per week but only after it is clear that they are permanent employees. However, by making this legitimate distinction, the employer would be forced to include all part-time employees in the eligibility test, even though it is certain that a very substantial portion of them will not remain with the company for very long. Similarly, a company may have changed its eligibility rules for part-time employees by increasing the hours standard, while grandfathering the part-time employees who were eligible at the time of the change. By continuing to allow these long-time employees to be eligible at a lower number of hours than newer employees, the employer must take all part-timers working the former hours standard into account in the eligibility test.

The extension of benefits eligibility to the permanent part-timers is directly in line with the policy objective of section 89. Furthermore, there is no situation which we have been able to construct in which an eligible part-time employee would be considered a highly compensated employee to whom discriminatory benefits could be offered. To deny the exclusion to the entire category because of the inclusion of permanent part-time employees is too extreme a result. Given that section 89 is intended to encourage broader eligibility for benefits, the "all-or-nothing" rule for excluding part-timers should not be allowed to create pressure to withdraw eligiblity from some part-timers in order to save the qualification of the plan in general.

Similar problems arise with respect to employees who have not completed six months of service, who are under 21 years of age or who work on a seasonal basis. The volume of turnover among new employees during the first several months is so high that many employers have concluded that offering a plan to such employees does not make good business sense. Allowing those employees who are under 21, those with less than six months service and those with seasonal employment patterns to be excluded represents a sound policy judgment that such employees are the least likely people to become a part of the employer's stable, permanent work force for whom benefits are a relevant matter -- particularly when they are not full-time employees. However, extending eligibility to employees in these categories who are part of the permanent workforce should not deny the entire exclusion.

As is the case with the part-time employees, we are not aware of any situation in which employees in the under 21 or seasonal categories would be highly compensated employees to whom discriminatory benefits would be offered if such persons were made eligible. Therefore, we urge that the rules be revised to allow for the exclusion of all persons in these categories. It is possible that employers could distiguish between highly compensated and nonhighly compensated employees based on initial periods of service, so there may be a reason to have a somewhat tighter rule in this category than in the others. However, even here, we urge that the denial of the exclusion not be based on an assumption than there is a discriminatory motive at work.

2. Separate Testing

Under current law, certain excludable categories can be tested separately to determine their compliance under section 89 in lieu of the denial of the exclusion for the entire category. We understand that the separate testing rule was contained in original section 89 to mitigate the harshness of the all-or-nothing exclusion discussed above and to provide a basic fairness rule. As presently drafted, H.R. 1864 would delete this provision -- subsection (h)(5) -- from proposed section 89. We urge that this separate testing approach be retained.

To the extent that highly compensated employees could be favorably affected in some manner by a "true exclusion" discussed above, the separate testing rule allows the nondiscrimination rules to be applied without adversely affecting the employer's plan generally. As long as it can be shown that these people do not turn the general category of employees with less than six months service into a discriminatory category, their presence should not adversely affect the ability of the plan to meet the requirement of new section 89.

3. Reduced Percentage or Sliding Scale Penalty

While the problems of the 90 percent rule under current law would be reduced using the 25-hours standard for the part-time employees, the deletion of the separate testing rule and the absence of the true exclusion push in the opposite direction. Therefore, the 90 percent threshold remains very high.

Two options are available for mitigating the severity of the 90 percent test while still achieving the policy objective and avoiding complications in the administration of the proposed section 89 rules. The simplest approach is to lower the eligibility threshold to something in the 70 to 80 percent range. There is precedent for both numbers; in the pension area, the rules require a qualified pension plan to meet a 70 percent eligibility test, and the proposed regulations for current section 89 apply an 80 percent test in the large employer rules.

But fixing a percentage at 70 percent or any other number presents the same "cliff" effect with respect to the penalty. Failing the test by one percentage point or less still subjects the highly compensated employees who are not receiving a discriminatory benefit to full inclusion of the benefit in income.

An alternative approach is to revise the all-or-nothing penalty in proposed section 89(b)(1) by lowering the percentage at which the "cliff" occurs and using a simple sliding scale above that percentage, based on the "133 percent exclusion rule" in subsection (b)(2). For example, if 90 percent eligibility were to remain the threshold for the maximum exclusion from income and 70 percent eligibility were established as the minimum for partial exclusion, the amount excludable from income by highly compensated employees could be determined using a scale of multipliers applied to the nonhighly compensated employees' benefits. The following table illustrates this approach.

Eligibility Percentage	Multiplier
90 percent	133 percent
85 percent	125 percent
80 percent	115 percent
75 percent	107 percent
70 percent	100 percent
less than 70 percent	0 percent

In addition, consideration should be given to permitting the use of a higher multiplier (such as 150 percent) if the plan's eligibility percentage reaches above 90 percent.

Conclusion

The simplified design-based concept which is presented in H.R. 1864 for health plans represents a dramatic improvement over current law. With certain revisions to technical features of the 90 percent eligibility test, we believe that H.R. 1864 will represent the needed replacement for current law.

TECHNICAL APPENDIX

A. Core Benefits

Under proposed section 89(c)(2)(A), a qualified core health plan is defined in part as a plan consisting primarily of core benefits.

Recommendation: We support your decision to define the term "core benefits" in the same manner as defined in the proposed Treasury regulations and in the Joint Committee Staff's Explanation of H.R. 1864 ("Joint Committee Staff's Explanation") (i.e., as comprehensive major medical and hospitalization benefits). As under present law, coverage for dental or vision care, and health coverage provided under flexible spending arrangements should not be considered core health benefits. It is also important that core benefits be defined generally, rather than specifically, to complement the flexibility inherent in the 133 percent benefits test. Any attempt to define core benefits by reference to required coverages, copayments or deductibles would unduly restrict employer flexibility in plan design.

B. Premium Limitations

Under proposed section 89(c)(2)(B), a qualified core health plan is defined in part as a plan which does not require employee contributions in excess of $10.00 per week ($25.00 per week for family coverage), indexed for cost-of-living adjustments.

Recommendation: The premium limitations and the employer-provided benefit should be adjustable to permit an employer to take account of geographic differences in premium costs. In addition (i) the premium indexing should be based on a medical, rather than a wage, index; (ii) the premium limitation should not include all pre-tax employee contributions without adjustment for tax savings; and (iii) the premium limitations should be adjusted regarding former employees to reflect higher costs and the adverse selection inherent in retiree coverage.

C. Family Coverage

Under proposed section 89(c)(2), a "qualified core health plan", contains separate premium limitations for individual and family coverage. Also, the computation of an employee's taxable benefit contains a special rule for family coverage under proposed section 89(b)(2)(B).

Recommendation: The term "family coverage" should be clarified in the manner described in the Joint Committee Staff's Explanation (i.e., coverage for both the employee and the employee's family). In addition, alternative premium limitations should be adjusted on a per dependent basis for family coverage (e.g., employee plus spouse, employee plus one child and employee plus two or more children).

D. Valuation Methods

Proposed section 89(e)(3)(B) states that the value of employer-provided coverage is to be determined under procedures prescribed by the Secretary.

Recommendation: The bill should confirm that an employer is permitted to use alternative valuation methods including COBRA cost, actual employer cost and values determined under reasonable actuarial methodologies. In addition, to provide certainty to employers, the transitional valuation rules enacted in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) should be made permanent.

E. Employees Working Less Than 30 Hours per Week

Proposed section 89(e)(5) provides a special rule permitting a proportionate increase in the employer-provided benefit and the premium limitations for employees who work less than 30 hours per week.

Recommendation: The bill should confirm that the term "proportionately increased" will be defined in the manner described in the Joint Committee Explanation, except that a 40-hour-per-week standard should be used to adjust the employer-provided benefit and premium limitations for employees working between 25 and 30 hours per week. A 40-hour-per-week standard more accurately reflects the normal work week of a full-time employee receiving employer-provided health coverage.

F. Union Employees

Proposed section 89(e)(8) provides that proposed section 89 may be applied separately with respect to employees included in a qualified bargaining unit.

Recommendation: The bill makes significant progress towards simplifying nondiscrimination testing for union employees. It would be appropriate to exempt union employees from the premium limitations (especially with respect to plans maintained under existing collective bargaining agreements).

G. Former Employees

Proposed section 89(e)(9) states that, except to the extent provided in regulations, proposed section 89 shall be applied separately to former employees under requirements similar to the requirements that apply to employees.

Recommendation: Additional guidance is needed with respect to the treatment of former employees under proposed section 89(c)(2)(B). For example, former employees should be defined with respect to some age and service criteria; the group of former employees against which compliance is measured should be defined; and the premium limitations for such employees should be adjusted to reflect higher costs and adverse selection that are characteristic of this group. In addition, consideration should be given to permanently grandfathering former employees retiring before the date that final rules are issued clarifying the application of the tests to former employees. The grandfather rule enacted in TAMRA (under which grandfather protection can be lost if benefits are increased) does not provide sufficient protection to employers. Many employers do not have, and cannot reconstruct, records identifying former employees and whether such employees were highly compensated. Precise guidance on these issues is needed because many of the changes to retiree benefits which are not within an employer's control (e.g., changes pursuant to state mandates or collective bargaining agreements) would deprive the employer of the TAMRA grandfather.

H. Plans Other Than Health Plans

The bill reinstates for group-term life insurance plans the nondiscrimination rules in effect prior to the Tax Reform Act of 1986.

Recommendation: The bill makes significant progress by providing that group-term life insurance plans are not subject to the section 89 rules. The bill should also clarify that accidental death and dismemberment plans and business travel accident plans are not subject to the nondiscrimination rules of section 89.

I. Salary Reduction

Under proposed section 89(e)(3)(C), salary reduction contributions are treated as employee contributions for certain purposes and as employer contributions for other purposes.

Recommendation: The effect of treating salary reduction contributions in this manner results in a "whipsaw" effect with respect to a highly compensated employee whose coverage is funded, in part, through salary reduction contributions. For example, assume that an employer makes a health plan worth $1,500 available to all employees and that highly compensated employees pay the full $1,500 on a salary reduction basis. Assume further that nonhighly compensated employees pay $500 on a salary reduction basis and that the employer pays the remaining $1,000. Under the bill, the 133 percent multiplier is applied against a base of $1,000, permitting a maximum tax-free benefit of $1,330. Because the highly compensated employees are treated as receiving employer-provided benefits equal to $1,500, they will have $170 of taxable income. This result is unfair, given that highly compensated employees and nonhighly compensated employees receive identical coverage, and that substantial employer contributions are made on behalf of nonhighly compensated employees but not highly compensated employees.

To correct this "whipsaw" effect, the bill should either (i) permit salary reduction contributions made by the nonhighly compensated to be taken into account to determine the base against which the multiplier is applied (or alternatively, to permit this result provided that restrictions similar to the TAMRA "corridors" are satisfied), or (ii) permit the use of a multiplier higher than 133 percent where salary reduction is made available for both nonhighly compensated employees and highly compensated employees.

J. Qualification Sanction -- 34 Percent Excise Tax

Proposed section 4980C imposes a tax equal to 34% of the amounts paid or incurred during any taxable year under a specified employee benefit plan if the plan does not meet the 5 requirements set out in this proposed section.

Recommendation: Proposed section 4980C should be clarified to specify exactly what amounts are included in computing the excise tax. We support the Joint Committee Staff's Explanation indicating that the provisions of the proposed Treasury regulations relating to severable coverage will apply in determining the amount of the excise tax. Additional relief should also be provided for situations (such as those involving multiemployer plans) where the employer may not have direct control over whether the qualification requirements are satisfied. Furthermore, consideration should be given to capping the penalty.

K. VEBA Rules

Under section 4976(c), an excise tax equal to 34 percent of the lesser of (i) the fund's discriminatory benefits or (ii) the fund's investment income is imposed on an employer that maintains a welfare benefit fund (e.g., a VEBA) which includes a discriminatory employee benefit plan.

Recommendation: The bill should clarify that the 4976(c) excise tax is imposed upon a failure to satisfy the 90 percent eligibility test, but not upon the payment of benefits in excess of the 133 percent benefit limit for highly compensated employees.

Mr. PICKLE. Thank you, Ms. Child.

Now, Mr. Satagaj.

STATEMENT OF JOHN S. SATAGAJ, PRESIDENT, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SATAGAJ. Thank you, Mr. Chairman. I appreciate the opportunity to testify today on the subject of Internal Revenue Code section 89.

The Small Business Legislative Council is a permanent, independent coalition of nearly 100 trade and professional associations that share a common commitment to the future of small business.

First, we must commend Chairman Rostenkowski and this committee for the forthright manner in which you have addressed the concerns of the small business community. H.R. 1864 is a positive start and, in our view, signals much good faith upon which we may be able to build a solution to resolve this dilemma. There are, of course, some concerns that we believe H.R. 1864 does not adequately address.

The most dramatic improvement accomplished by H.R. 1864 is to provide a high degree of certainty and simplification, in the process by incorporating elements of a design-based solution. Replacing the several nondiscrimination tests with a single test is a significant improvement.

The first point of concern we have, however, is how to define the parameters of the 90-percent test. In particular, we are interested in a realistic test that applies only to those workers who are full time and who are truly eligible for participation. It seems to us this can be achieved by lowering the percentage, altering the definitions of excludable employees, or some combination thereof.

The three major concerns are that redefinition of full-time workers include only those workers employed for 30 hours or more a week; that whole classes of excludable workers are not automatically included because of the extenuating circumstances of one individual; and, third, that the law include a flexible approach to dealing with individuals not included under a plan because of factors outside the control of the employer—for example, that the insurance carrier refuses to cover an individual.

Further, we would hope the committee would consider simplification of the qualification rules. In particular, we would prefer a design-based solution. For example, the IRS regulations on what constitutes "legally enforceable" now contemplate an ongoing, daily evaluation by the small business. If there is one thing about small business, certainty is an important rule for them.

The heart of H.R. 1864, in our opinion, however, is the requirement that an employer cannot ask an employee to contribute to health coverage in excess of a certain, specified amount. We believe the results of this, as currently drafted, may be contrary to what the objectives of the legislation are and will, in fact, discourage small employers from providing health insurance. We believe this is particularly true because what we are creating is a cost cliff. And what we find in a small business, is that when they decided to provide coverage, it is determined by the owner's ability to pay.

The prudent business owner is not likely to make a commitment until he or she is confident that the company can handle the cost.

Often, given the significant costs, particularly of dependent care, the company starts by contributing only a small share, perhaps 20 percent, and the employee is responsible for 80 percent. But the important fact is the employer is giving the employee an opportunity to get coverage. And as time goes on, the business owner, as he understands what the costs are, will begin to change that coverage. But the small business owner has to be confident that he can control the cost within his own program.

The result of H.R. 1864 is basically an all-or-nothing decision, and the result will be that the owner will postpone the decision to provide any coverage until he or she is confident that the company can consistently and comfortably handle the cost of coverage.

The bottom line is we need a system that provides flexibility in sharing the responsibilities, particularly for those businesses that are not yet providing coverage, because that is what is going to encourage employers to provide coverage.

Next, we would suggest that the wage growth index is not the proper index. Health care cost inflation is probably in the top three of any small business owner's concern today. Whenever you talk to them, the first thing they will bring up about health care is how much is it going to cost. The increases of 30, 40, 50, even 70-percent increase in the last few years is the most troubling thing to them. So if there is going to be an index, that index needs to reflect not only the issue of wage growth, but the employer's concern of health care cost inflation.

Finally, we come to the issue for which there is no easy answer. The perceived limitation on the small business owner's flexibility in the management of the business is going to be the cause of some concern with this legislation. But, in conclusion, we are very hopeful that we can arrive at a solution that will permit small business to do what it does best: create jobs and opportunities rather than doing more Government homework.

Thank you, Mr. Chairman.

[The statement of Mr. Satagaj follows:]

STATEMENT OF JOHN S. SATAGAJ
PRESIDENT SMALL BUSINESS LEGISLATIVE COUNCIL

We appreciate the opportunity to testify today on the subject of Internal Revenue Code Section 89.

The Small Business Legislative Council (SBLC) is a permanent, independent coalition of nearly one hundred trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached.

First, we must commend the Chairman and this committee for the forthright manner in which you have addressed the concerns of the small business community with regard to Section 89. H.R. 1864 is a positive start, and in our view signals much good faith upon which we may be able to build a solution to resolve this dilemma. There are, of course, some concerns that we believe H.R. 1864 does not adequately address. Although the remainder of our testimony covers these points, we want to underscore that we come to the table today with an optimistic outlook for a positive conclusion to this debate.

The most dramatic improvement accomplished by your proposal is to provide a high degree of certainty, and simplification, in the process by incorporating elements of a "design-based" solution. Replacing the several nondiscrimination tests with a single test is a significant improvement.

While you have addressed our concerns regarding part-time workers by increasing the number of hours for determining full-time employees from 17.5 to 25 hours, we believe this still does not reflect the economic realities of a small business. In particular, we believe the 90-percent test could be met if it were to be applied to those workers that a small business owner considers to be truly full-time workers. We believe that the appropriate threshold is 30 hours a week. Likewise, we believe the overall definition of excludable workers needs further revision for the same reasons.

Second, in the universe of the smallest of small businesses with twenty or fewer employees, the 90 percent test can produce inadvertent, but harsh results. For example, if a five-person firm is to meet the test, 4.5 workers would have to be covered and the only way such a small firm could comply is to cover five out of five employees.

Third, the law should include a simple method for excluding those workers who, under any circumstances, would be ineligible for coverage. In most such circumstances, it is the insurance company that informs the small business owner a certain individual cannot be included under a plan.

As to the definition of highly compensated employees, if the issue is affordability, ownership is not necessarily an indicia of prosperity in a small business. As provided in the proposal for officers, an accommodation should be made for *owners* not earning in excess of $45,000.

We would urge the Committee to include a clear, concise definition of core coverage.

We would hope the Committee would consider further simplification of the qualification rules. In particular, we would prefer a design-based standard. For example, the IRS regulations on what constitutes "legally enforceable" contemplate an ongoing, cumbersome evaluation. Certainty is important to a small business.

With regard to the benefits test, we believe most small businesses can work within the 133 percent range. The problem, however, is the parameters established by the bill. The bill compares the lowest premium of the nonhighly compensated employees' to that of the highly compensated employees. We believe this is an extremely severe test that will produce harsh results. A comparison of averages may be more realistic.

The heart of H.R. 1864, in our opinion, is the requirement that an employer cannot ask an employee to contribute to health coverage in excess of certain, specified amounts. Putting aside for a moment whether this is an appropriate public policy, let us assume, hypothetically, that such a concept will be accepted by small business owners.

We believe the most likely result of implementation may be contrary to the stated objectives of the legislation, and will discourage small employers from providing health insurance. We believe this will be particularly true in the case of family coverage. The reason we believe this will happen, is that mandating a limit on the employee share creates a "cost cliff." Under pre-Section 89 law, an employer phased in health coverage, beginning, most likely, with employee-only coverage. As the company grew and profits permitted, it expanded coverage and absorbed additional costs.

The decision to provide coverage is determined by the owner's ability to pay. The prudent business owner is not likely to make a drastic commitment until he or she is confident the company can handle the costs. Often, given the significant cost of dependent coverage, the company starts by contributing only a small share of family coverage, perhaps only 20 percent, but it does offer the employee the opportunity to secure coverage. Again, as time goes on, the package is improved. H.R. 1864 eliminates that flexibility. In a sense, the decision becomes an "all or nothing" decision. The result is that an owner will postpone the decision to provide any coverage until he or she is confident that the company can consistently and comfortably handle the costs of coverage. The proposal, as drafted, is too rigid to encourage employer activity. Fixed dollar limits only serve to delay coverage. A system that provides flexibility in the sharing of the responsibility will, more likely, encourage employers to provide coverage.

Second, we would suggest that wage growth is *not* the proper index for making future adjustments in the contribution levels. Health care cost inflation is probably in the top three of small business owner's overhead problems. No amount of planning or budgeting has helped a small business owner in this regard. If there is one lament we hear time and time again, it is, "When is this going to stop, my insurance carrier has just advised me of another 30, 50 even 70 percent increase in my costs." Any index, to be useful, must be linked to those unpredictable costs. We might add that the baseline of $10 and $25 is simply too low.

Finally, we come to the issue for which there is no easy answer. The problem is, H.R. 1864 moves a step closer to imposing employer responsibility for employee welfare, which small business owners perceive to be unnecessary and unwarranted government interference. Small businesses value their employers and we believe, voluntarily, attempt to do whatever they can to address their needs. This must be accomplished, however, within the context of the owner's judgment of what the business can accommodate to survive and prosper.

We know the taxpayer is already making a significant tax expenditure to encourage employers to provide health insurance coverage. It is the incremental change, advanced by this bill, to which small business owners will object. It is the perceived limitation on the small business owner's flexibility in the management of the business that is the cause of significant concern.

It has been our philosophy, in recent years, to make every effort to disseminate information to small business on new regulatory programs as quickly as we can. We do this through compliance guides and seminars. The Immigration and Naturalization Service's (INS) I-9 program and OSHA's Hazardous Communication (HCS) program are two examples of programs for which SBLC undertook major education initiatives. We believe it is our responsibility to accept the mantle of leadership and promote cooperation between the government and small business. On occasion, our efforts to educate reveal the flaws in these regulatory schemes.

Typical of the response we have heard from small business, is the story told to us by Valerie Hansen, Chief Executive Officer of Big Buck Building Centers of Racine, Wisconsin. Valerie is a member of an SBLC member, the

National Lumber & Building Material Dealers Association. Her company is 50 percent retail, with two traditional full-service lumber yards, and 50 percent wood-products manufacturing, with a truss plant and architectural millwork company. In 1988 her company's gross sales were $11 million. The company currently employ 88 people; 80 are full-time and some of the employees are covered by union contracts.

It is an established company, having been founded sixty years ago by her grandfather. That means they have survived the Great Depressions, World War II, material shortages, wage and price controls, inflation, and sky-high interest rates. One year in the early 1980's, their home town of Racine issued only one residential building permit. As she says: "We are resilient folks in a highly competitive industry."

As a small business owner, her goal is to serve her customer's needs in a timely fashion and at a fair price. She has observed that: "As a lumber dealer, I need to focus on my customers and the efficient purchasing and delivery of goods. I also must focus on employee growth, team building, improving productivity, and leading the company through its seventh decade."

With regard to Section 89, her company has already invested $3,000 in preliminary data collection and in simply trying to understand the regulations. Her best guess is that she may be able to finish the actual test and comply for $7,500 or roughly $94 per person. At the current corporate tax rate of 34 percent, she estimates this will cost the federal government $2,550 in tax revenue. She anticipates no ultimate liability to her company from Section 89.

Her current annual cost for providing employee health coverage is $189,000. And health care is just one of many employee benefits the company provides.

How significant can the cost of providing health insurance be on her total business? The numbers, based on patterns that already exist, are illustrative. Her analysis is based on information from the top half of the lumber and building material industry -- in other words, good, solid companies.

Over the past several years, the average employer cost of providing health care benefits in her industry has averaged 1.8 percent of gross sales. Her health care costs have averaged 2.0 percent of gross sales. Assuming a 5 percent increase in gross sales volume per year, and assuming optimistically they experience a 5 percent increase in gross profits per year, how long will it take until the very viability of the business is threatened if the cost of health care benefits increases 20 percent per year, while all other expenses (such as salaries, insurance, etc.) are held to 5 percent increases?

She tells us it would be seven years. She estimates that in seven years the top firms in her industry will face operating losses instead of profits, with health care coverage as the only item out of balance to other basically inflationary increases. It can certainly be argued that 20 percent is a conservative number. Many small businesses have experienced premium increases in the 50+ percent range and limitations on the coverage of the insurance they can afford. This extrapolation is based on continuing to cover the employee group as it is presently defined, without the additional mandates of Section 89.

Her company has completed a Section 89 "pre-test" to develop basic date on her employees. In doing so, they looked at all W-2 employees for two years. One hundred-ninety-five employees were examined and forms were completed for each. About one-half were union members, being fairly evenly divided between the Teamsters and Carpenters Unions. The preliminary analysis is that neither union contract, as presently structured, will meet the Section 89 requirements. Both involve health plans controlled by an independent group of trustees. The current Teamsters' contract expires July 1, 1989. The contract is traditionally for three years and involves multiple employers covering two counties in southeastern Wisconsin.

Her conclusion, after reviewing the likely impact of Section 89 on her business, was to tell us: "Small business persons are vitally concerned about affordable, quality health care for themselves and their employees. For the most part, small business owners know their employees on a personal level. And, ultimately, we know that our employee's best interest is directly served by maintaining a viable business. Mandates, like Section 89, diminich small businesses' ability to be profitable and do little to meet the individual needs of employees."

We believe any regulatory scheme should allow small business owners an opportunity to bring their programs into compliance. Whether it is the OSHA HCS program or Section 89, the penalties should be prospective, contingent upon failure to comply within a certain time frame once an agency has served warning upon the individual company.

We believe that Congress should not require small businesses to jump through the "hoops" at every turn. Once a small business owner has brought his or her program into compliance, the owner should be permitted to rely on its efforts without going through the machinations necessary for compliance, year in and year out. In effect, we need a "stand-still" agreement with the government, good for a period of time.

The final problem we have with the current Section 89, is the lack of effective communication by the government. Congress and the IRS must ensure that small business owners understand their responsibilities before the effective date and this communication must consist of more than notice of the effective date. As I indicated earlier, we understand we have a responsibility as well. While not perfect, the INS' I-9 program is a good model of how to communicate. The INS did undertake a major effort to inform the business public of the requirements through the dissemination of written and video material. In fact, if I recall correctly, the INS used the IRS list of business establishments for distribution of this information.

In the case of Section 89, we believe this would have reduced the likelihood of mass hysteria. For example, most small business owners automatically assume Section 89 applies to all benefits. They assume it applies to automobiles, vacations, tickets to events or memberships in clubs. Clear, simple information, in advance would have eliminated some major headaches. Unfortunately, small businesses are still working to comply with the relatively recent changes in fringe benefit rules, and in many instances do not fully understand which benefits are includible or excludible from the employee's income. This confusion includes the proper application of definitions of working condition fringe benefits and de minimis fringes. We believe early dissemination of this type of information is essential.

Section 89, as it is presently structured, fuels a dilemma with which small business is confronted on an all too frequent basis. Complicated regulatory requirements create an underground community of owners who say, "This is just too difficult, I'll take my chances and wait to see if they catch me." We do not want that to happen, and we believe most small business owners do not want it. We know some owners will eliminate jobs if Section 89 is left as it is. Others will simply eliminate every employee's benefits. The way to ensure compliance is to be realistic and flexible in the development of laws and regulations.

We find a new undercurrent within the small business community. Under the patina of optimism, lies a layer of frustration. For the first time in a decade, we have heard small business owners suggest the price of doing business is just too high, and the price of doing business is paperwork and regulation. In this nation, we assume entrepreneurship has perfect elasticity; that is, no matter what the cost of entry, more Americans will want to own the American dream. It may not be so. A few examples of the relatively new regulatory schemes with which small business must comply include the I-9 program imposed by the Immigration Reform and Control Act; the Hazardous Communication Standard Program; the underground storage tank program; the hazardous waste program created by the RCRA; several other tax compliance items, such as the passive/active rules; new transportation licensing requirements; plant closing notification rules; polygraph-use restrictions and notice; and, new credit card disclosures. State and local governments have also initiated unprecedented oversight of business.

We do not want to be whiners. Small business has always taken the attitude, "We'll survive it." This time, let's let them go about the business of doing business, not government homework. Thank you.

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Air Conditioning Contractors of America
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National Asphalt Pavement Association
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National Council for Industrial Innovation
National Electrical Contractors Association
National Fastener Distributors Association
National Grocers Association
National Independent Dairy-Foods Association
National Knitwear & Sportswear Association
National Lumber & Building Material Dealers Association
National Moving and Storage Association
National Office Products Association
National Paperbox & Packaging Association
National Parking Association
National Precast Concrete Association
National Shoe Retailers Association
National Society of Public Accountants
National Tire Dealers & Retreaders Association
National Tooling and Machining Association
National Tour Association
National Venture Capital Association
Opticians Association of America
Petroleum Marketers Association of America
Printing Industries of America, Inc.
Professional Plant Growers Association
Retail Bakers of America
SMC/Pennsylvania Small Business
Small Business Council of America, Inc.
Society of American Florists
Specialty Advertising Association International
United Bus Owners of America

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Mr. Pickle. Thank you, Mr. Satagaj.

Now we will hear from Alice Griffin, representing the National Small Business United. Please proceed.

STATEMENT OF ALICE B. GRIFFIN, PRESIDENT, GRIFFIN PENSION SERVICES, INC., SOUTH HAMILTON, MA, ON BEHALF OF NATIONAL SMALL BUSINESS UNITED

Ms. Griffin. Congressman, like my peers before me here, I am very grateful that we have this opportunity to talk with you today about section 89 and the much-improved compliance requirements of H.R. 1864.

I am an owner-operator of a small business. I have 12 employees. I am also active in small business organizations such as National Small Business United, and I think this morning—or this afternoon, representing those 50,000 small business companies, I can perhaps shed some further light from personal experience on how H.R. 1864 will impact our constituency.

We are not in favor of discriminatory benefits, and we are absolutely anxious to work with you and the members of this committee to see that affordable health care is extended to all workers. Our problems are not unlike some that I have heard earlier today. The first of them is, of course, the employee contribution to premiums based upon both geographic differences and wage differences and even on the way we in small business pay for our health insurance. The way our premiums are determined, we think that there must be some different manner in determining what is affordable, recommending that it be perhaps the greater of $10 or 5 percent of pay, and $25 or 12 percent of pay, and that being indexed to that medical CPI that we have heard before.

You know, when we go to buy life insurance in a small company, all of our employees have to complete a questionnaire on their own health and on the health of their dependents. Each one of our employees is underwritten individually. The same employee who is age 25 will pay a lesser premium than the employee who is 55 for the identical coverage. So we are going to have some problems in age discrimination with the way you are categorizing affordability here.

That takes me to the 133-percent rule. In my environment, an employer who agrees to provide health insurance for his employees is generally providing only one plan. We are really lucky if we find one plan that will cover our employees. We are not talking about multiple plans, but we are dealing with the problem of differing premium levels.

I can see with the 133-percent rule here where we would have discrimination attached to an employee who is talking about the very same coverage but his premium is larger than the smallest employer that the bill addresses, simply on the basis of the way the programs are underwritten. And I suggest that this legislation should show that where we are talking about identical coverage, we should not be attributing any excess penalty to the employees who are in that category merely on the basis of the way insurance is underwritten.

In small business, we have some issue with the eligibility rule at 25 hours per week. We think that should be 30. Because of the nature of my business, I have almost on a daily basis dealt with much of the confusion that the qualification rules have caused, and I think they are going to continue to do that because people are uncertain if this refers to their retirement plan or to how many different kinds of benefit plans they must have, in fact, to satisfy the qualification rules. I think if we are going to look at some simplification, we should simply address health insurance at this point in time and delay the qualification rules for some of the other statutory benefits that are suggested.

Another concern of mine is the vagueness in the law. I think that there are some problems which could result from section E, where we see terms like "employer-provided benefit" and "determination of value." And I think we are going to find that those may hold us up in actually being able to implement this legislation. So I urge the committee to go back and make sure that we do not find that an issue to be delayed by Treasury.

One last point on small companies. We have heard today about those who are organized as sole proprietors, partnerships, and even under subchapter S corporations. In those instances, the principals are not deducting the cost of their premiums except at the level of 25 percent. So we have many, many of our small businesses who are, in fact, not able in any way to show discrimination. Their employees are, in fact, covered by programs, and their premiums are completely deductible. But your so-called highly compensated in those firms are not even able to deduct the cost of their premiums. We think there should be much greater consideration for the equity of the deductibility of health care cost for all of those people who are willing to take the risk in small business. And we hope that you will look to resolve that inequity as we discuss these areas of discrimination and fairness and simplicity.

Thank you.

[The statement of Ms. Griffin follows:]

TESTIMONY BY ALICE B. GRIFFIN
GRIFFIN PENSION SERVICES, INC.

Mr. Chairman and Members of the Committee:

My name is Alice Griffin of Griffin Pension Services in South Hamilton, Massachusetts. My small business is a benefits consulting firm where my clientele is some 500 other small business owners. I am a member of National Small Business United.

We at National Small Business United express our thanks to you Mr. Chairman for the opportunity to address the House Ways and Means Committee on our concerns about Section 89. As you may well know, National Small Business United is the oldest association exclusively serving the small business community of our nation--for over 50 years now. NSBU has a membership of over 50,000 individual companies with members in each of the 50 states, as well as local, state, and regional organizations. NSBU is uniquely qualified to express the views of the small business person.

We appreciate the opportunity to play a constructive role in the process of reforming Section 89. Along that path, the reform bill introduced by Chairman Rostenkowski (HR.1864) is a definite improvement over the status quo. Specifically, some of the improvements initiated by HR.1864 would:

- Move from a participation-based plan to a design-based plan. This is the basic change from which most of the other simplifications flow;
- Greatly simplify the testing process; small businesses can understand this proposal and make decisions without hiring benefits consultants, CPAs, and attorneys to guide them through the current maze of regulations;
- Reduce costs and eliminate most of the paperwork burden. The mammoth data collection efforts required under present law would be essentially eliminated, cutting back dramatically on non-insurance compliance costs;
- Remove the penalties for employer non-compliance from employees;
- Raise the number of hours part-time employees must work in order to be a considered employee in the nondiscrimination tests.

In his floor statement introducing HR.1864, Chairman Rostenkowski alluded to the social goals which Section 89 was designed to attain: Increasing the availability of health insurance and making it available on a more equal basis. Those are laudable goals to which we subscribe. It is our belief, however, that there are several changes that could be made in HR.1864 to further these goals still more. To that end, we would like to offer the following comments:

As currently written, HR.1864 requires that employers offer core health insurance to at least 90 percent of their non-highly compensated employees at an employee cost of no more than 10 dollars per week for individual coverage and 25 dollars per week for dependent coverage. These fixed-dollar amounts would be indexed to wage growth. Highly compensated employees may not have employer-paid benefits excluded from income that are more than 133 percent of the smallest employer-paid premium made available to 90 percent of the non-highly compensated employees.

One of the largest problems with HR.1864 is the requirement that employers offer core health insurance to 90 percent of their employees. There are occasions when employees are uninsurable or can only be insured at astronomical cost to the employer. In the case of employees who may have a pre-existing medical condition (e.g., cancer, even pregnancy), insurers will either refuse to insure those employees or will only agree to insure them for a premium the employer cannot afford. In other words, it is not always up to employers who they insure; it is very often a decision of the insurance companies. Employers who cannot offer insurance to 90 percent of their employees should not be forced to suffer; the offer of insurance to 90 percent of insurable employees--at reasonable rates--should be sufficient.

Another problem with the 90 percent requirement needs some clarification. If a small business has eight employees, the bill states that it must offer core insurance benefits to 7.2 of them. It is our contention that employers should always be able to round down to the next number. Otherwise, employers with fewer than ten employees will always be forced to offer health insurance to 100 percent of their employees.

The caps on employee contributions of 10 dollars for individual insurance and 25 dollars for family coverage are designed, understandably, to assure that employers do not simply place employee contributions so high that lower-paid employees are priced out of the health care market. However, there are serious problems with the way this principle is implemented in HR.1864. First, both insurance costs and wages are highly responsive to geographics. These absolute figures may be entirely reasonable in one region of the country and totally unreasonable in another. A worker where wages tend to be lower, may not be able to afford more than 10 dollars per week for insurance; a worker doing the same job in a more affluent area may have no problem affording a much higher contribution.

Not only is it true that wages for the same job vary across the nation, it is also true that the equity of a fixed number for employee contributions varies across a given work-force. Those working at or near minimum wage may not be able to afford a contribution greater than 10 dollars, but other employees certainly could. The high rate of employer contribution for all employees will mean that the overall quality of the health care package will be reduced for all employees.

Worse, though, than the fixed and inflexible caps set on employee contributions is the manner in which those caps will be indexed. In recent years, health care cost inflation has far outstripped wage inflation. The proposal is to index them to wage inflation when the cost of health insurance has nothing to do with wages. That sort of indexation may keep employee contributions to a minimum, but it will also have the effect of reducing overall access to health care. Even if the employee contributions were reasonable in the beginning, health care inflation would insure that employers would bear an ever-increasing share of the health care burden.

We would like to suggest a solution to these problems created by the inadequacy of the flat dollar amounts of employee contributions. NSBU recommends that employee contribution caps for individual and family coverage would be more appropriate at 10 dollars and 25 dollars or 5 percent and 12 percent of income, respectively--whichever is greater. This would allow individuals who make up to $10,400 per year to pay no more than 10 dollars per week for insurance. At the same time, those who could afford to pay a greater share of their health insurance would be able to do so. In order to keep this equitable distribution in place, we recommend that the employee contribution cap be indexed to increases in health care costs. This sort of indexation would allow employers to continue a quality health care plan.

The Committee must also understand that small businesses purchase health care insurance on an individual basis. They often pay vastly different premiums on different employees--based upon age, sex, and past medical history--for exactly the same coverage. The difference in these premiums can often be 200 percent or more. Yet, HR.1864 prevents premiums worth more than 133 percent of the value of the smallest employer-paid premium from being excluded from the taxable income of highly compensated employees. It should be realized that highly compensated employees tend to be older employees, and older employees also tend to have more extensive medical records. It will be the case that many of these employees will be paying taxes on the high cost of their insurance even when their coverage is no greater than other employees'--simply because they are older or have greater medical difficulties. We suggest a system whereby the non-excludable portion of employer-paid premium for highly-compensated employees would be that which exceeds 133 percent of the average employer-paid contribution. Further, at no time should benefits that are the same as those received by others be taxed simply because of higher premiums. This change would help ameliorate many of the concerns of small business and prohibit what would essentially amount to age discrimination.

We also recommend an increase in the minimum weekly hours for employee participation from 25 hours to 30 hours. Small businesses often rely heavily upon the part-time job market. This proposal--although there is an increase from the hours in Section 89--would still produce devastating effects upon the part-time job market. Thirty hours per week seems a much more reasonable and acceptable standard.

The penalties section raises some concerns. For violation of the qualification rules, there is a 34 percent excise tax imposed upon employers for all health premiums paid during the time of violation. Under certain circumstances, this tax is punitive. For example, employers may well be in complete compliance with the non-discrimination standards of this proposal, yet be hit with an enormous tax for failure to produce a particular document they may not have been aware was necessary. We propose an exemption from this penalty for those employers who are in compliance with the non-discrimination standards.

Further, we propose the penalties section be delayed for one year; in the interim, employers should be properly notified of their obligations under these regulations (as with the mass of I-9 forms concerning employers' responsibilities under the new immigration laws). Once employers are properly made aware of their responsibilities, a more appropriate penalty would be revocation of the deductibility of their premiums, rather than a 34 percent tax.

Mr. Chairman, providing adequate and broad-based health care is going to be an expensive assignment. While we realize that the budget situation may not allow it at this time, we believe that allowing 100 percent deductibility of health insurance for non-incorporated entities is one of the best ways to extend that coverage. Employers should be helped to afford appropriate health coverage for their employees--not punished if they cannot afford it. If we intend to correct discrimination in the allocation of employee benefits, we must also correct discrimination in the tax code. Non-incorporated entities should receive the 100 percent deduction for proprietors, partners, and Sub-S shareholders for health care costs afforded large corporations. Small businesses ask for both a level playing field and the means to comply with these extensive government requirements.

Again, we would like to thank the Committee for the opportunity to testify. I have not in this testimony attempted to cover every base, only those we see as most critical to small businesses. We will be happy to answer your questions about other issues raised by the bill. We have met with your staff and Chairman Bentsen's staff and intend to continue our work with them and the eventual conferees. We look forward to playing a meaningful role in producing a constructive resolution to this important issue.

Mr. PICKLE. Well, I thank you, Ms. Griffin. Let me ask that you submit to the committee any examples you might have had in your experience working with the small groups that would be helpful to us. One point you made, you questioned whether the premiums are sufficient because of regional differences. I would like to know in your judgment what the differences are. How much do they vary in different parts of the country?

Now, you are from Massachusetts. Would your premiums be higher, the costs higher than in my part of the country? Do you know?

Ms. GRIFFIN. I am sure they would, Congressman Pickle. As I look at these numbers right now, I know that for many of the small companies, already the employees are being asked to pick up a higher share of the premium. We are close to Boston, and our health costs are high. And I am sure that is replicated in cities throughout the country.

Mr. PICKLE. Now, Ms. Child, let me ask you a question. You mentioned that you are concerned about the 90-percent test.

Ms. CHILD. Yes.

Mr. PICKLE. And I think one of the other witnesses, maybe Mr. Satagaj, also is concerned about it. I take it that your main concern is that we do not have any true exclusion test about the present approach.

Ms. CHILD. That is correct.

Mr. PICKLE. We do not take into consideration under 21 or less than 6 months or part-time employees. If we had a true exclusion in these cases, would that help us cure the 90-percent test?

Ms. CHILD. Yes, sir. That would help considerably.

Mr. PICKLE. Now, if we did make certain exclusions, would then you be willing to keep the 90-percent test?

Ms. CHILD. We are still interested in looking at a sliding scale as an alternative to the 90-percent test's "cliff effect" but the true exclusion, I believe, would address the problems identified by our group.

Mr. PICKLE. Well, somebody had recommended that we just eliminate this 90-percent test completely. I believe, Mr. Larsen, you indicated that. Did you?

Mr. LARSEN. No, I did not.

Mr. PICKLE. But if you get a true exclusion, then would you as a panelist accept the 90-percent test?

Mr. SATAGAJ. Certainly, I enumerated three things in the inclusion: the part-time issue, those other exclusions, and those who were excluded for non-employment-related circumstances, such as medical reasons. If those items were parts of what is a true employee, then I think there would not be as great a problem determining what the number actually is. I think you make a valid point.

Mr. PICKLE. Well, if the premiums are not sufficient, the $10 and $25, I do not think any of you recommended what level you think it should be. Did you?

Mr. LARSEN. I did, Congressman, yes. I suggested that it be an allowable procedure for a company to pay either a flat dollar amount or, in the alternative, a percentage, a uniform percentage of all employees' costs, because there are so many variables. I did a study of the National Association of Wholesalers program just taking the districts represented by the members of this committee, and there is an 89-percent swing in the highest medical cost to the lowest.

Mr. **McGrath**. Would the gentleman yield?

Mr. **Pickle**. You would give them an option, then.

Mr. **Larsen**. Yes.

Mr. **McGrath**. Would the gentleman yield on that?

Mr. **Pickle**. I will recognize you, Mr. McGrath.

Mr. **McGrath**. We were looking at that from the affordability aspect and were contemplating perhaps a percentage. We just want to get a handle on what that percentage might be. What might be a realistic percentage in order that that percentage does not become a disincentive for employers to either increase or maintain the level of benefits that they already have?

Mr. **Larsen**. We were not looking so much to a stipulated percentage, just so long as whatever the employer chose was uniform for the entire employee sector, both the highly compensated and the nonhighly compensated. So the firm that wanted to pay 80 percent of the expense for an employee and 50 percent for dependents could do so without regard to the specific dollar impact of that, but would be treating everybody in a uniform manner.

Mr. **McGrath**. I am just wondering if we let it become that loose that we may have a problem with a higher revenue impact somewhere later down the line.

I have no further questions, Mr. Chairman.

Mr. **Pickle**. Mrs. Kennelly.

Mrs. **Kennelly**. No questions, Mr. Chairman.

Mr. **Pickle**. Mrs. Johnson.

Mrs. **Johnson**. Yes, I would like Ms. Griffin to comment on the same question. I notice in your testimony you recommend that we go to a percent rather than the dollar amount. Would you like to discuss that or would any of the other panelists like to discuss that? Because it is a very difficult issue for members who represent such an enormous variety of businesses.

Ms. **Griffin**. Well, that is something I would like to speak to, and thank you.

I think the question has been asked how we determine an appropriate percentage level, and I know that many small companies determine what percentage the employee should pay of their premium costs based upon what is generally the norm within their own local governments, their cities, and towns. That is where we compete for workers and so on. In many situations in Massachusetts, the employees are paying 50 percent of their premiums, so the employers have been using that as their guideline.

Mrs. **Johnson**. Other comments?

Mr. **Larsen**. I was just going to comment on that. There is a factor always at work today in insurance programs whereby the underwriter will not allow you to be arbitrary in terms of what percent of employees are covered. Almost every group insurance plan requires 75-percent participation among the eligible employees in order to extend the coverage. In some of your self-insurance schemes, that might not be the case, but the insurance contracts usually operate in that manner.

So if you set the percentage too low, you probably would not find yourself meeting the insurance company's 75-percent requirement. So the situation as it exists absent section 89, there are already certain policing mechanisms aimed at avoiding discrimination against the insurer, where you would include only the people with chronic illnesses.

Mr. **Satagaj**. If I might add another point, Mr. Larsen suggested that the employer set the percentage, whatever it is. There is a second advantage to that, and it is the problem I talked about for those businesses that are not yet offering insurance, to encourage them to get into the program. They can take it a step at a time. You know, maybe it is going to be this percentage today; down the line, when they can better afford it, they will increase the percentages. So that removes some of the disincentive when you fix the cost for people that put their toe into the water. So I think there is some additional advantage to what Mr. Larsen suggested.

Mrs. **Johnson**. We would set minimum percentage participation rather than minimum dollar?

Mr. **Larsen**. Well, I think the insurers are variable on that point, but there is a rather strong consistency at the 75 percent of eligible employee level. Now, they allow in the insurance contracts the ability to not include in the eligible class those that are covered by other insurance programs, those covered by collective-bargaining agreements, part-time employees and so on.

Mrs. **Johnson**. And in that 75 percent, do they include part time?

Mr. **Larsen**. Typically not. As a matter of fact, they are typically precluded from coverage.

Mrs. **Johnson**. Thank you.

Thank you, Mr. Chairman.

Mr. **Pickle**. Would any of the members of the panel be willing to comment on the possibility of setting the maximum employee premium as a percentage of compensation? Anybody want to comment on that approach? Ms. Griffin.

Ms. **Griffin**. I think in our testimony, my testimony from National Small Business United, we have suggested that it should be the greater of $10 or 5 percent of pay, and for the dependent coverage, $25 and 12 percent of pay.

Mr. **Pickle**. Anybody else?

Mr. **Larsen**. In practice, that is very unusual. There is not many—we have a pretty good overview; with NAW's 45,000 member corporations, we see the structure of many programs. In my own experience, fewer than 2 percent would be setting the employer contribution as a percent of salary. You would end up rewriting so many existing plans if you move in that direction.

Mr. **Pickle**. All right. Thank you. I thank the panel very much for your testimony.

Now, before we ask the next panel to come out, I am going to ask our colleague, Congressman LaFalce, if he will come forward. Mr. LaFalce is chairman of the Committee on Small Business, and he was scheduled to have testified this morning. We understand, Mr. LaFalce, that you have been a little busy over on another committee marking up some savings and loan matters. I know it has been difficult for you to be here.

Before we proceed with the next panel, I would be happy to recognize you, Mr. LaFalce.

STATEMENT OF HON. JOHN J. LaFALCE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK, AND CHAIRMAN, COMMITTEE ON SMALL BUSINESS

Mr. LAFALCE. That is very kind of you, Mr. Chairman, and I want to thank you for taking me out of order and being so sympathetic to the peculiarities of the congressional schedule.

I would like to ask unanimous consent to include the entirety of my testimony in the record.

Mr. PICKLE. Without objection, it will be ordered.

Mr. LAFALCE. Thank you.

First of all, I would like to reiterate the point that I have made, and that is the pleasure I have taken at Chairman Rostenkowski's introduction of H.R. 1864. When he introduced that bill with the cosponsorship of so many members of the Ways and Means Committee, he said that it completely replaces existing section 89 of the Tax Code with a new, substantially simplified program. I truly hope that a final product which, in fact, does that and respond to the concerns raised about H.R. 1864 can be achieved, and I surely hope to work with you in that endeavor. Because if it could not, then complete repeal of section 89 would be the only alternative.

Also, Mr. Chairman, I am pleased to have learned yesterday that the Bush administration has seen fit to join us in trying to relieve the burdens of section 39 on American employers. Secretary Brady's announcement yesterday that he will delay implementation of the compliance process until October 1 will give American employers much-needed relief and should, I hope, give us here in Congress the opportunity to bring about the kind of meaningful change which we all seek.

I do think that January 1, 1990, would have been a better choice than October; however, I hope that we can act before October 1. If not, then we would perhaps have to persuade the administration to consider extending the relief through the entire calendar year.

As I understand it, section 89 was enacted to ensure that favorable tax treatment not be provided to sustain unreasonably higher levels of benefits for the highly compensated, and to encourage health insurance coverage for a greater number of American workers, particularly those at the lower end of the economic scale. The bill that I introduced to repeal section 89 was based on my view that, as presently written, it was likely to have a seriously counterproductive effect. It would have achieved the exact opposite of what was intended.

As chairman of the House Committee on Small Business, I heard from many individual businesses and their representatives here in Washington about the burdens of compliance with section 89. Some of the most distressing news that I heard was that many such employers were seriously considering dropping any health insurance plans at all in lieu of trying to meet the test in section 89 and risking the penalties if they did not meet the guidelines.

There was a substantial likelihood that section 89 would backfire; that in the final analysis it would result in fewer Americans having access to employer-sponsored health insurance rather than more. And as I looked into the issue, I learned that this problem was not limited to small business or even to businesses, period. All employers in the United States were affected: every level of government, every school board, every college and university, every not-for-profit organization, every labor union, you name it. Each had to collect voluminous data and prove, year in and year out, that their health insurance plans were not discriminatory. And providing that proof would not be easy or inexpensive.

The Committee on Small Business held hearings on this issue earlier this year. Some of the experts who testified said that the total annual cost of complying with section 89, as presently written, could come to billions of dollars. This is when the revenue estimates were coming to about $100 to $150 million.

Given the fundamental problems with section 89, I came to the conclusion that surely we should seek a more efficient way of addressing the objectives of improved health coverage and nondiscrimination. It was my thought that we should simply repeal section 89 and then consider what the next step should be. Three hundred of our colleagues joined with me in this effort, and so right now we have 301 cosponsors of that bill.

Now, I understand the fact that Chairman Rostenkowski wishes to replace existing section 89 with something new immediately and simultaneously, and I am willing to work with you in that effort.

Before I go into the specifics of the bill that the Ways and Means Committee has before it now, let me put in a plug for another bill. That is a bill that I introduced last year and I have introduced again this year. If you want to talk about discrimination, I really think the greatest discrimination we have in the law right now with respect, for example, to health benefits is the law which gives 100 percent deductibility to a business that is incorporated, but to a business that is not incorporated and is offering the same type of benefits gives 25 percent deductibility.

Now, 25 percent is better than nothing. I understand that. But if the only difference is the difference in legal character of the business, then I do not think that that type of discrimination should exist within the Tax Code. And I would urge you to consider expanding that 25-percent coverage to the exact same coverage that incorporated businesses get, immediately, if possible. If not immediately, then in some phased-in manner, from 25 to 50 to 75 to 100 percent. But at some point in time, it seems to me, we ought to eliminate the discrimination that exists in the Tax Code with respect to the legal nature of the business, the legal entity being dealt with.

With respect to the bill that Chairman Rostenkowski has introduced, I do not want to get into a highly detailed discussion of each of the bill's provisions, although in my prepared testimony I tick off around 25 different sections where I suggest that the Ways and Means Committee consider alternative ways of dealing with the issues in question.

Let me just mention one for purposes of this brief discussion right now, and that is employee contribution limits and indexing. I think that surely can be made more equitable. I think that the $10 per week for individual health coverage and $25 per week for family coverage, tied to changes in the wage-based inflation index, does not take into consideration regional differences in both pay and in medical costs. The same health plan might cost $100 per month in one area, $150 in another. And comparable employees in those areas might earn $20,000 in the first instance and $30,000 in the second.

As drafted, H.R. 1864 could result in each employee contributing $10 per month, thus penalizing the lower paid employee, at least in a relative sense, and similarly penalizing the employer in the area with the higher health insurance costs.

Second, using a wage-based index would have the effect of building in a continual increase in the employer's share if present trends prevail. Inflation in health care costs and health insurance premiums has been substantially higher than inflation as a whole. As this cost of doing business rises, American employers may become less competitive or, in the alternative, will find it necessary to scale back the health insurance programs which they offer to their employees.

One solution might be to limit the percentage of the health insurance premium paid by the employee. This would eliminate regional disparity and the need for an index, although it does leave questions regarding deductibles, copayments and the employer who self-insures.

Another alternative is to make the limit a percentage of the employee's income, and this, too, would relieve regional inequity and eliminate any need for indexation. And since deductibles, copayments and self-insurance would not loom as large using this approach, it may be the best way of solving this problem. This committee has much greater expertise than I in this area, so I will leave it to your discretion. But, in any event, I would urge the committee to move away from the dollar limit and the index, if possible, and devise another way of ensuring that lower income workers could have reasonably equal access to this most important benefit.

There are a good many other areas that I think should be considered: the definition of part-time employees, the eligibility criterion, the cafeteria plans, the benefits test, the qualifications test, multiemployer plans, the effective date, et cetera.

I would urge, in considering all of these areas, however, that this committee not try to solve every single hypothetical hazard if in doing so we are going to bring about pain or confusion or undue compliance burden for the vast majority. If abuses do come to light in the future because we have not considered every single hypothetical situation, we could address them at that time.

I believe that with the leadership of the Ways and Means Committee a simplified, understandable, workable, and equitable solution can be found. The members of the Ways and Means Committee have been leaders in the effort to simplify our tax laws, and in the process enabled individuals, businesses, and other elements of our economy to spend their time doing productive, useful tasks. I do believe that H.R. 1864 can become an appropriate vehicle through which we can pursue that same philosophy with regard to section 89 and the serious complications it has engendered.

With appropriate modifications as outlined in my written statement, I would be very pleased to continue working with the chairman and the members of this committee for bringing this to a rapid and satisfactory conclusion.

Thank you.

[The statement of Mr. LaFalce follows:]

REMARKS OF REP. JOHN J. LaFALCE, CHAIRMAN
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

BEFORE THE
COMMITTEE ON WAYS AND MEANS
MAY 2, 1989

Mr. Chairman, thank you very much for affording me the opportunity to appear before your Committee today.

Before moving to the substantive points I'd like to make, let me first reiterate my pleasure that you, Mr. Chairman, Majority Leader Foley, and several members of this Committee have introduced legislation which, as you said when introducing H.R. 1864, "completely replaces existing Section 89" of the tax code with a new, substantially simplified program. I hope that a final product which does that and responds to the concerns raised about H.R. 1864 can be achieved, since the only alternative would be complete repeal.

As I understand it, the introduction of non-discrimination guidelines in the area of health insurance was intended to do two things: ensure that favorable tax treatment not be provided to sustain unreasonably higher levels of benefits for the highly compensated, and to provide incentives to encourage health insurance coverage for a greater number of American workers -- particularly those at the lower end of the economic scale. Effective incentives to accomplish that end will help bring down the number of Americans not now covered by health insurance -- a staggering 37 million people, half of them workers and half of that number employees of smaller businesses.

The bill I introduced in January to repeal Section 89 was based on my view that, as presently written, it was likely to have a seriously counter-productive effect. As Chairman of the Committee on Small Business, I had, of course, heard from many individual businesses and their representatives here in Washington about the burdens of compliance with Section 89. And some of the most distressing news I heard was that many such employers were seriously considering dropping any health insurance plans at all, in lieu of trying to meet the tests in Section 89 and risking the penalties if they didn't meet the guidelines.

This told me that there was a substantial likelihood that Section 89 would backfire -- that in the final analysis it would result in fewer Americans having access to employer-sponsored health insurance, rather than more.

As I looked further into the issue, I learned that this problem was hardly limited to small businesses. Indeed, all employers in the U.S. were affected. Every level of government, every school board, every college and university, non-profit organizations, labor unions, you name it. Each one had to collect voluminous data and prove, year in and year out, that their health insurance plans were not discriminatory. Providing that proof would not be easy or inexpensive.

The Committee on Small Business held hearings on this issue earlier this year. Some of the experts who testified at those hearings said that the total annual cost of complying with Section 89 as presently written could come to billions of dollars.

Importantly, little if any of these expenditures will strengthen our economy or increase our productivity. And in my view the likely costs of Section 89 are too high a price to pay for a problem which is, I believe, probably quite limited in scope. Surely we should seek a more efficient way of addressing this issue. The fact that nearly 300 of our colleagues have co-sponsored H.R. 634, my bill to repeal Section 89, tells me that there was and is a large number of Americans who concur with this conclusion. And Mr. Chairman, your bill provides the potential framework for just such an approach.

Before proceeding, I would like to put in a plug for another bill I introduced as a companion to H.R. 634. This bill deals with discrimination regarding the tax treatment of health insurance benefits as well.

What I'm speaking about here is discrimination by the United States of America against one unique group of citizens -- self-employed individuals who, for whatever reasons, have not seen fit to incorporate. While corporations can deduct 100% of the employer-paid health insurance premiums (presuming they meet Section 89 requirements), including those pertaining to owners of the business, unincorporated enterprises are treated differently. Prior to 1987, no health insurance premiums paid on behalf of owners of this form of business were deductible as a business expense. The Tax Reform Act of 1986 changed this; at present, 25 percent of such premiums qualify as a business expense.

And this does not affect business owners alone. Rather, the existence of this distinction between incorporated and unincorporated businesses has been, as my friend and colleague Pete Stark said when he introduced similar legislation last year, "a significant disincentive to the provision of health insurance" to all employees in these businesses -- employers and employees.

I recommend that this Committee move forward on this issue as soon as possible. Surely we should start the process of ending the discrimination we created simply by differentiating on the basis of the legal character of a business. We could accomplish this by providing 100 percent deductibility in one step or, as has been proposed, we could phase it in by increasing deductibility from 25 to 50 percent this year, 75 percent next year and then 100 percent in 1991.

Mr. Chairman, I do not want to devote my time here today getting involved in a highly detailed discussion of your bill's provisions. Other witnesses no doubt will do that. Rather, if I may, I would like to discuss one issue in some depth and then just briefly note those areas where, I believe, some refinement might be considered, and leave the detailed analysis to others with more expertise than I.

Employee Contribution Limits and Indexing. The issue I would like to discuss at some length is one which impacts each and every employer and employee and which, I believe, can be made more equitable than is the case in H.R. 1864 as presently written. I refer here to the employee contribution limits of $10 per week for individual health coverage and $25 per week for family coverage, along with a proposal to tie these limits to changes in the wage-based inflation index.

I have two problems with this provision. First, it ignores regional differences in both pay and medical costs. Equivalent health plans might cost $100 per month in one area and $150 in another. And comparable employees in those areas might earn $20,000 in the first instance and $30,000 in the second. As drafted, the proposed new Section 89 could result in each employee contributing $10 per month, thus penalizing the lower paid employee (in a relative sense) and, similarly, penalizing the employer in the area with the higher health insurance costs.

Second, indexing the limits to the wage element of the CPI will have the effect of building in a continual increase in the employer's share, if present trends prevail. Inflation in health care costs, and health insurance premiums, has been substantially higher than inflation as a whole. As this cost of doing business rises, American employers may become less competitive or, in the alternative, will find it necessary to scale back the health insurance programs which they offer to their employees.

One idea would be to put a limit on the percentage of the health insurance premium to be paid by the employee. This would eliminate regional disparity and the need for an index, but we would have to wrestle with questions regarding deductibles and co-payments under various plans, to say nothing of trying to figure out how to apply such a test in instances where an employer self-insures.

Another suggestion for dealing with this problem is to make the contribution limit a percentage of the employee's income. This, too, would relieve regional inequity and eliminate any need for indexation. And since deductibles, co-payments and self-insurance would not loom as large using this approach, it may be the most appropriate way of solving the problem.

In any event, I would urge the Committee to move away from the dollar limit and the index, if possible, and devise another way of ensuring that lower-income workers can have reasonably equal access to this very important benefit.

As I said before, there are some other areas which may warrant further consideration. I will simply run down the list and let the experts provide you with the details on why a problem exists and how it might be addressed.

Definition of Part-Time Employee. Historically, a 30-hour week has been traditional as the dividing line between "full-time" and "part-time" workers. I recommend that the Committee consider this in lieu of the 25 hour standard in the bill.

Eligibility Criterion. Some feel that the requirement that 90% of the rank and file be eligible for a plan establishes a very steep cliff. The point is made that this is particularly difficult for the smallest employers. I would suggest that the Committee consider using the 70% standard which, I understand, is used in the pension area. Alternatively, a sliding scale depending on the size of the employer might be appropriate.

Cafeteria Plans. An irony here is that a number of so-called "Cafeteria Plans" which qualify under the present Section 89 would not qualify under H.R. 1864. I would hope that the Committee would seek ways to eliminate this anomaly.

Benefits Test. As I understand it, the 133 percent test in H.R. 1864 differs from the comparable test in the existing Section 89 in that it compares the lowest level of benefits received by an individual employee in the non-highly compensated category against the highly compensated employees, whereas the present Section 89 compares the average of those in the non-highly compensated group against the highly compensated group. Perhaps we should consider keeping the average as the testing benchmark. Incidentally, I would also ask that you make it clear that the test be based on the insurance premiums, whether or not you follow my suggestion concerning elimination of the valuation process.

Qualification Tests. A primary concern here is that Congress should make sure that the IRS understands that we want reasonableness to govern in their interpretation of these standards, for many do not trust the IRS to act reasonably on a matter of this kind without specific exhortation.

This is particularly important in light of the penalty for non-compliance: the 34 percent excise tax. Indeed, Mr. Chairman, I would join those who recommend that you consider lowering the penalty. My purpose here would be to avert instances where an employer might decide to eliminate benefits to all employees due to fear of inadvertent non-compliance with the qualification tests and the financial consequences of such an event. Related to this, I believe it imperative that the legislation make clear that any excise tax would be applied based only on employer-paid premiums and not on benefits received by employees.

Multi-Employer Plans. Employers who contribute to multi-employer plans are concerned that their ability to assure that a plan qualifies and is non-discriminatory is seriously limited. These employers, who are concentrated in the construction industry, make cash contributions to the plans' trustees but have little if anything to say about the plan and its administration. Data collection would be very difficult since employees come and go so frequently. Somehow we should try to deal with these legitimate problems and concerns while guarding against potential abuses. But in this area as in others, Mr. Chairman, I don't think we should try to solve every single hypothetical hazard if, in doing so, we bring about pain or confusion for the vast majority. Should serious abuses come to light in the future, we can always address them at that time.

Effective Date. I believe there is a substantial likelihood that Congress will enact major changes to replace Section 89 this year. But it is also possible that final action may not be reached in the near term. In these circumstances I have two recommendations: that we include a provision in the bill making those changes effective on January 1, 1990, and that we relieve employers' burdens during the balance of 1989 by working with the Bush Administration to seek action which would effectively, and immediately, defer any present necessity to comply with existing Section 89.

In addition to these, I would encourage you to devote some attention to other areas of concern including: definition of a qualified core health plan, the problems of defining and dealing with leased employees and independent contractors, valuation of benefits, excludable employees, and collectively bargained plans.

Mr. Chairman, this may seem to be a long laundry list, but I think that there is merit to the concerns that have been raised about all these issues and I would urge you to give careful consideration to the testimony of others which will, I have no doubt, provide detailed analysis as well as potential solutions to the various problems.

The United States faces many challenges as we head into the 21st Century. Not least is our ability to continue to compete in the world economy.

Free enterprise is the cornerstone on which our economic system is built. You and your colleagues on this Committee, Mr. Chairman, have been leaders in the effort to simplify our tax laws and in the process enable individuals, businesses, and other elements of our economy to spend their time doing productive, useful tasks. I believe that H.R. 1864 can become an appropriate vehicle through which we can pursue that same philosophy with regard to Section 89 and the serious complications it has engendered. With appropriate modifications as outlined in this statement, I will be pleased to continue working with you toward bringing this to a rapid and satisfactory conclusion.

Mr. Chairman and my colleagues, thank you again for the chance to appear before you today. I would be pleased to respond to any questions you might have.

Mr. **Pickle**. Well, I thank you, Mr. LaFalce, and I want to thank you personally on behalf of the committee for the leadership you have shown on this subject. It has been a very prominent item on your agenda of the small business group and understandably so. Obviously, it has an instant appeal because you would not have had 301 Members sign up asking us to volunteer to hold these meetings. The fact that we have done it is an indication that you have tested the temper of the independent business people out there and business as a whole. So, of course, we thank you for it.

Now, I appreciate your last statement when you said that you do not think that we ought to try to cure every hazard out there. I appreciate you taking that broad attitude. I recognize also you made some 25 recommendations. I assume you want me to correct the 25 first and then not try to cure all the other hazards. [Laughter.]

I am sure that is true of all the others. But you have made some good suggestions. Earlier, we had discussed the possibility that perhaps we ought to look at the premium with respect to regional charges, regional costs. Do we index to CPI or do we index it to the compensation of an employee? Both are points which you had made.

I think we would have to consider the 90-percent question in some aspect to try to get something a little more reasonable. But the only thing I would say to you is that we do have a new measure. The old or the present law is complicated, and without intentionally doing so, though it achieves the purpose, it was a complicated problem. And we are hoping this will be a much more readily acceptable approach.

I just want to say to you and your committee that we are going to keep the nondiscrimination aspect. It is not going to be repealed. If somebody wanted to repeal it, they could have repealed it 2 years ago. But there has been no suggestion on that. We are going to maintain that because that is right as a principle of law, but we certainly can do a better job than we did originally. I hope that we can do that. Your leadership has meant something to our committee, so we thank you.

Mr. **LaFalce**. Thank you.

Mr. **Pickle**. Now, Mr. McGrath.

Mr. **McGrath**. Thank you, Mr. Chairman. Welcome, John. Thanks for your contributions.

When we first started discussing section 89 and changing it in one fashion or another, we articulated some problems that we thought we could fix. One of them was the collection of data problem. Do you agree that H.R. 1864 solves that problem by going to a design-based——

Mr. **LaFalce**. I think that H.R. 1864 substantially solved not only that particular one, but most all the compliance burden problems. And I think the committee and you and Mr. Anthony, in particular, along with the chairman and ranking minority member, should be commended for that.

I think that we have with H.R. 1864, as Mr. Rostenkowski said, a complete replacement, de facto repeal. But now we are talking about a new section 89, and I think that there are some—if I had to choose between the old section, or the present section 89 and the new proposal, I would certainly choose the new. But if we had nothing on the books and somebody wanted to introduce H.R. 1864 de novo—there was nothing on the books—I would say, hey, we have an awful lot of problems with this. And before we pass it, let us consider all the elements.

I think that is what I am asking you to do right now. Before we pass H.R. 1864 as the replacement for existing section 89, let us consider these problems, and I have ticked off some of them.

Mr. **McGRATH**. Let me tick them off, too. One of the problems that we had discussed was the inclusion in the original 90/50 test of part-time employees, and we both agreed that the 17.5-hour standard was not reasonable. It is now 25 hours in the bill. Is that more reasonable?

Mr. **LAFALCE**. It is more reasonable. Make it 30, and we have a deal.

Mr. **McGRATH**. We discussed in prior months the problem of former employees, and we have made that prospective. Is that being more reasonable?

Mr. **LAFALCE**. I think you are being more reasonable throughout.

Mr. **McGRATH**. I guess the big problem that we have heard about today is the affordability test and the $10-per-week standard for individuals and the $25-a-week standard for families. I am wondering whether you have a better solution to that. We have been discussing all day some sort of percentage. Do you have a better answer to that?

Mr. **LAFALCE**. Well, I have suggested a percentage, and you can say a percentage of what. And there are different approaches that could be taken. I think perhaps a percentage of the employee's income might be the best approach, but I would defer to the greater expertise of this committee on that.

I think it should be a percentage. Then the question is a percentage of what.

Mr. **McGRATH**. Well, we have seemingly come a long way. I am not adverse to opening up whatever we have in front of us for—

Mr. **LAFALCE**. Another percentage would be what percentage should the employer pay, what percentage should the employee pay.

Mr. **McGRATH**. Oh, we are talking about affordability, though.

Mr. **LAFALCE**. Yes. I personally believe the percentage of the employee's wages, compensation, would be a better approach. But I think reasonable people could differ. I think the percentage approach, though, is much, much preferable to the dollar limitation.

Mr. **McGRATH**. My understanding is that in a large number of cases, the $10 figure pretty well covers some of the individuals, and may be a little bit of a problem for the $25 for family. What is your understanding of how realistic these premium levels are?

Mr. **LAFALCE**. I think it depends upon where you are employed, is it a big business, is it a small business, is it in the Northeast, is it in the Midwest, et cetera. I really do not have that data.

Mr. **McGRATH**. Do you believe that there ought to be any exceptions at all to the enforcement of section 89?

Mr. **LAFALCE**. As it is presently——

Mr. **McGRATH**. Not presently, but in a new statute. For example, do you believe that there ought to be a small business exemption?

Mr. LaFalce. A small business exemption? There is a small business exemption in a great many provisions of the law: for the minimum wage, for parental leave, et cetera. The Treasury Department today, I understand, has expressed sentiment for consideration of a small business exemption, and surely as chairman of the Small Business Committee I think it should be considered for any law.

Mr. McGrath. How about State and local collectively bargained units?

Mr. LaFalce. Well, it depends what we are trying to get at. If we are trying to get at true discrimination, do we think that the Federal Government discriminates? Do we think that the State governments discriminate or local governments?

Mr. McGrath. Well, perhaps not, John. But my problem is there are perhaps collectively bargained agreements in the private sector, too.

Mr. LaFalce. True.

Mr. McGrath. If we exclude municipalities on the one hand because they are collectively bargained, then don't we also have to exclude collectively bargained private sector plans?

Mr. LaFalce. I think the question is: What would the reason for the exclusion be? If the reason is because of the likelihood of discrimination, then you might be excluding one cast of characters and not another. If the reason for the exclusion is because of the difficulties of complying, then clearly the most likely ones to be excluded would be the small business people. And so if it is the difficulties in coming up with these types of benefits for all your employees, if it is a difficulty of cost, if it is a difficulty of compliance burden, whatever the extent of the compliance burden is, the ones that would be most desirous of and most in need of an exemption would be the small business community.

Mr. McGrath. How about 501(c)(3) organizations?

Mr. LaFalce. It depends how big or small they were. If they fell within the definition of small, I would surely want to exempt them also.

Mr. McGrath. I guess my point is that when we start, we can exempt everybody from the provisions of the law.

The last question, if I have time, Mr. Chairman, concerns multiemployer plans. I am wondering whether you have any good suggestions about how these plans should be treated?

Mr. LaFalce. This is a very complex area, and I do not have the expertise to address the type of special treatment that is necessary for multiemployer plans.

Mr. McGrath. I can understand the problem if you are a——

Mr. LaFalce. I do not have my own solution for that, no. I would simply say let us work with the multiemployers and the unions of the multiemployers in trying to come up with something that is workable. I would surely defer to your greater expertise in this.

Mr. McGrath. I am not sure we have any greater expertise on this particular subject. I recognize the problem. For example, in some cases an employee can work for four different companies in a day if they are working on the docks in New York or perhaps four different construction jobs in a week which gives us some consternation as to how we handle this.

Mr. **LaFalce**. You see, when we are dealing with these multiemployer plans, I would think almost all the individuals working for them do get benefits.

Mr. **McGrath**. Well, then they could be tested under their union plan, should they being union, but I do not know the answer.

Mr. **LaFalce**. I do not know.

Mr. **McGrath**. Thank you.

Mr. **Pickle**. Mr. LaFalce, I certainly thank you again. We all must appreciate the leadership you have given to the committee and to the Congress. Because of it, I think we will see a much better bill in the process. So we thank you very much for your testimony.

Mr. **LaFalce**. Thank you very much, Mr. Chairman.

Mr. **Pickle**. Now, the next panel—they have been waiting patiently here all day—consists of Donald C. Alexander, Robert Fay, James Gardner, and Ernest May. You individuals please come forward.

This panel consists of Donald C. Alexander, who is [illegible] member of the board of directors of the U.S. Chamber here. He is [illegible] partner in Cadwalader, Wickersham & Taft, and Alexander; and Robert Fay, who represents the Associated General Contractors; then James Gardner, who represents the National Federation of Independent Business; then Ernest May, who represents the National Candy Wholesalers Association.

Mr. Alexander, if you will proceed first. All of your statements will appear in the record.

STATEMENT OF DONALD C. ALEXANDER, MEMBER, BOARD OF DIRECTORS, U.S. CHAMBER OF COMMERCE, AND PARTNER, CADWALADER, WICKERSHAM & TAFT, WASHINGTON, DC

Mr. **Alexander**. Thank you, Mr. Chairman, for adding my name to my firm name. I am not sure my partners have agreed to that yet, but I will take that up with them this afternoon.

Mr. **Pickle**. Well, you know, we get promoted to being Senators quite often, and there is no reason I cannot add your name to the firm.

Mr. **Alexander**. Mr. Chairman, I think of you as far beyond any Senator, sir.

I do not intend to read any part of my statement. Mr. Chairman, you mentioned this morning that we were not going to deal with nits but you were interested in major problems. I would like to focus on two of them.

You focused on one of them earlier today when you asked whether the 90 percent test left enough wiggle room, and it does not. Furthermore, the 90 percent test is not a nondiscriminatory test anyway. You could have a nondiscriminatory plan, Mr. Chairman, if 50 percent of the highly compensated group were members of the plan and 55 percent, say, of the lower compensated employees were in the plan. If anything, that is bottom heavy rather than top heavy, but that kind of plan is forbidden under H.R. 1864.

Now, H.R. 1864 is a great step forward, but it can stand some improvement to solve major problems. Not everybody's problems, but some major ones. One of them is the 90-percent test. The 90-

percent test is basically mandated benefits through the tax system. You have got to cover 90 percent, or your plan does not qualify. Why?

In the pension area, which you and I went through back in the ERISA days, we had ultimately decided upon a 70-percent test. Seventy percent was decided on as being an adequate test for nondiscrimination if preventing discrimination in giving tax benefits to otherwise deductible charges is the goal.

So the first point that I hope this committee focuses on is whether that 90 percent leaves enough wiggle room. We think it does not. We hope you drop it. We suggest the pension model as a sound one.

Now, the other point I had, Mr. Chairman, skipping the rest of my statement, deals with the multiemployer plans that Mr. McGrath was asking about a minute ago, and the 34-percent excise tax under this new section 4980(c). If a plan fails to meet one of the qualification standards as implemented by 40 or 50 pages of regulations, then the employer gets stuck with a 34-percent excise tax on the contributions to that plan.

Now, in a multiemployer plan where the employer contributes into a plan which covers people that work part of the year for that employer, people that work part of the year for maybe dozens of other employers, the employer has no right whatever to administer the plan. The plan is administered by trustees, an administrator who is chosen pursuant to the collective bargaining process. So the employer has no control over the multiemployer plan, but the employer would be charged with an enormous tax penalty if the multiemployer plan does not comply with all these tests that are set out in section 4980(c) to be implemented by regulations, of which we already have close to 50 pages implementing the tests under section 89(k), which is the counterpart in the current law.

That is another major problem, sir, and I hope it will be addressed.

[The statement of Mr. Alexander follows:]

STATEMENT
on
H.R. 1864
before the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U.S. CHAMBER OF COMMERCE
by
Donald C. Alexander
May 2, 1989

My name is Donald C. Alexander, and I am testifying today on behalf of the U.S. Chamber of Commerce. I am a member of the Chamber's Board of Directors and a partner in the law firm of Cadwalader, Wickersham & Taft.

The Chamber is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents nearly 180,000 businesses and organizations, such as local/state chambers of commerce and trade/professional associations. More than 92 percent of the Chamber's members are small business firms with fewer than 100 employees, 59 percent with fewer than 10 employees.

The subject of today's hearing, employer-provided health benefits, is critically important to the Chamber and its member companies. For many of these companies, health benefits are the largest component of labor costs after salaries and wages. Those employers who are committed to providing health benefits to their employees have had to struggle in recent years with a dramatic escalation in the cost of medical care and medical insurance. The escalating cost of medical insurance has hindered the spread of employer-provided health coverage to certain categories of employees and certain lines of business.

While we may all agree that adequate health insurance for every American is a worthy goal, the subject of today's hearing is limited, I believe, to the issue of discrimination. Many employers would resist federally mandated health insurance coverage, but most of them would agree that the exclusion of employer-provided health benefits from an employee's gross income cannot be defended if the benefits are limited to a small group of highly compensated employees.

I think it is safe to predict that today's hearing will reveal a consensus on two fundamental points. First, highly compensated employees should not derive tax benefits from employer-provided health plans that discriminate against rank and file employees. Second, the antidiscrimination rules contained in section 89 of the Internal Revenue Code are not workable and must be replaced. The Chamber applauds Chairman Rostenkowski, Congressman LaFalce, and the many other members of Congress who have listened to their constituents' concerns about section 89 and acted to address those concerns.

As you know, the Chamber has advocated the repeal of section 89 and a return to the nondiscrimination rules that applied before section 89 took effect. We continue to believe that prior law, with some modifications, would provide adequate safequards against discrimination. At the same time we wish to provide a constructive response to the Chairman's proposal to reform section 89 rather than repealing it.

H.R. 1864, the Chairman's simplification bill, does respond to a number of the problems identified by the business community. The proposed 25-hour-per-week standard for part-time employment is far more realistic than the current section 89 standard. Allowing leased employees to be excluded from testing when the leasing organization provides core health coverage is an improvement for the many employers that must rely on temporary help from employee leasing organizations. In allowing collectively bargained plans to be tested separately, H.R. 1864 recognizes that employers cannot control the collectively bargained portion of their benefit programs.

What we like best about the Chairman's bill is its simple and straightforward approach. The rules of section 89 are so complex that it has been difficult to hold a meaningful discussion on how to improve them. The Chairman's bill, in contrast, is an excellent starting point for discussion. The Chairman has called for constructive suggestions on his bill that will facilitate compliance with section 89 without abandoning the goal of nondiscrimination. Although the Chamber is not in agreement with all features of the Chairman's bill, I hope that you will find our suggestions today to be constructive. They are certainly offered in that spirit.

As we see it, the Chairman's bill has three principal features. First, all highly compensated employees will be taxed on their health benefits unless the employer offers core health coverage to at least 90% of the non-highly compensated employees, with a dollar limit on employee contributions. Second, every highly compensated employee is taxed to the extent that his employer-provided health benefit exceeds 133% of the lowest level of health coverage taken into account by the employer in passing the 90% test. Third, the employer must pay a 34% excise tax on all of the health benefits provided to its employees unless the health plan satisfies all of the following requirements: the plan must be in writing, employees' rights under the plan must be legally enforceable, employees must be given notice of all benefits under the plan, the plan must be maintained for the exclusive benefit of employees, and the employer must intend that the plan be maintained indefinitely.

I 90% Eligibility Test.

I would like to focus first on the requirement that 90% of all non-highly compensated employees be eligible for coverage. The Chamber does not object to the concept that rank and file employees must have an opportunity to participate in a tax-favored health plan. However, prior to enactment of section 89, the concept of nondiscrimination, whether applied to health benefits or pension benefits, meant that the percentage of highly compensated employees eligible to participate should not be unreasonably different from the percentage of non-highly compensated employees eligible to participate. The 90% eligibility test in H.R. 1864 is not a test for discrimination, it is a test of universal coverage.

Consider, for example, an employer that owns a shoe factory and provides health benefits to all of the factory workers as well as to the highly compensated factory managers. Assume that this employer purchased another shoe factory and that neither the managers nor the workers receive health benefits at the second factory. The health plan provided at the first factory would continue to satisfy traditional nondiscrimination tests if, taking the two factories together, the percentage of highly compensated employees eligible for health benefits was about the same as the percentage of rank and file employees who were eligible.

Under H.R. 1864 the employer in our example could not satisfy the nondiscrimination rules unless he dropped the health plan in the first factory or expanded the health plan to include the second factory. This does not seem right to us. A health plan that covers 50% of the highly compensated and 50% of the rank and file is not a discriminatory plan and should not be penalized as a discriminatory plan.

Some employers are in an economic position to provide health benefits to all of their employees. Some employers cannot afford to provide health benefits to any of their employees. The message implicit in the 90% test is that, if you cannot afford to provide health coverage to all of your employees, you might as well not provide it to any; just increase the pay of the highly compensated and let them buy individual coverage.

Is this really the message that Congress wishes to send? The first step for an employer that provides no coverage at all may be to adopt a plan for 30%, 50%, or 70% of its employees. As long as the coverage is extended to roughly comparable percentages of rank and file and highly compensated employees, a plan that covers 30%, 50% or 70% of employees should not be subject to tax penalties. The Chamber therefore believes that the 90% test in H.R. 1864 should be replaced by the traditional nondiscrimination requirement that the percentage of highly compensated employees eligible to participate not be unreasonably different from the percentage of rank and file employees who are eligible.

The traditional approach to nondiscrimination is embodied in the rules that govern pension plans and other qualified plans that defer compensation. Under these rules, a savings plan will satisfy the statutory coverage requirement if the percentage of non-highly compensated employees eligible to participate is not less than 70% of the percentage of highly compensated employees who are eligible. Any qualified plan that actually benefits at least 70% of non-highly compensated employees will automatically satisfy this requirement. (*See* I.R.C. § 410(b)(1)(A), (B).)

The 90% test in H.R. 1864 measures whether eligibility for a health plan is universal, not whether it is discriminatory. The pension plan rules, in contrast, were specifically designed to measure nondiscrimination. We therefore urge the Committee to adopt those rules as the model for section 89. Specifically, any group of comparable health plans should satisfy section 89 if 70% of non-highly compensated employees are eligible to participate or if the percentage of non-highly compensated employees who are eligible is at least 70% of the percentage of highly compensated employees who are eligible.

II 133% Benefits Test

Under both current law and H.R. 1864, an employer can pass the 90% eligibility test even if the health benefits for highly compensated employees are significantly better than the health benefits for the rank and file. Section 89 deals with this possibility by taxing highly compensated employees to the extent that their benefits, on average, exceed 133% of the average benefits received by rank and file employees. H.R. 1864 includes a similar rule, but the test is far more severe. Rather than looking at the *average* benefits of the highly paid and the non-highly paid, the bill compares what each highly compensated employee receives to the *lowest* benefit that is taken into account in passing the 90% test. More than any other feature of the bill, the 133% test imposes burdensome problems of measurement and calculation on employers. The employer, for example, must determine the value of benefits under each of the different plans that is offered.

The Chamber believes that the 133% test of H.R. 1864 is unnecessary if the Committee replaces the 90% eligibility test with a test that compares the percentages of highly compensated and non-highly compensated employees who are eligible. As long as each of the basic categories of medical coverage, such as core coverage, dental care, vision care, and family coverage, are offered to approximately the same percentage of highly paid and non-highly paid employees, a health benefit plan should be treated as nondiscriminatory. In the case of plans that require substantial employee contributions, it could be argued that comparable rates of eligibility are not adequate protection against discrimination. If mandatory contributions are too high, rank and file employees may be financially unable to take advantage of the plans for which they are eligible. However, the Chairman's bill deals with the problem of burdensome contribution requirements by treating plans that require employee contributions above a particular amount as if they were not really available to rank and file employees. The 133% test should therefore be abolished for plans that do not require employee contributions in excess of the dollar limits in H.R. 1864.

Under H.R. 1864, plans that require an employee contribution in excess of the specified dollar limits cannot satisfy the nondiscrimination tests, and the highly compensated participants in such plans will be taxed on all of their health benefits. The Chamber believes that a plan should not be treated as discriminatory merely because of the amount of required employee contributions. If a plan requires employee contributions in excess of the dollar limits of H.R. 1864, there is a possibility, but by no means a certainty, that a disproportionate share of the benefits will go to highly compensated employees as a result of low rank-and-file participation. The 133-1/3% test under current law would tax highly compensated employees whenever a mandatory employee contribution substantially reduced participation by the rank and file. The Chamber therefore recommends that plans having mandatory contributions in excess of the dollar limits of H.R. 1864 be treated as nondiscriminatory whenever such plans are available to comparable percentages of highly and non-highly compensated employees, but that the 133-1/3% test of current law be retained for such plans. The 133-1/3% test should be based on average benefits, as under current law.

III 34% Excise Tax

The Chamber has very serious problems with the third principal feature of H.R. 1864, the imposition of a 34% excise tax on benefits provided under plans that do not meet the five requirements I described previously. While at first glance these five requirements may seem simple enough, the March 7, 1989 proposed regulations required 50 pages to describe them. In these proposed regulations, the Internal Revenue Service (IRS) has construed the requirement that a plan be in writing as authority for the IRS to mandate much of the contents of the written plan. For example, the proposed regulations require that the plan include a recitation of the five statutory requirements. (Prop. Treas. Reg. § 1.89(k)-1, Q&A 3(c)(2).) This requirement alone will mean that virtually every health benefit plan in the United States must be rewritten. Based upon the statutory requirement that the plan be legally enforceable, the proposed regulations have even intruded on basic features of health plan design. For example, the proposed regulations provide that the provision of any alternative medical care under the plan must be based upon the consent of the employee, presumably regardless of how costly is the form of medical care preferred by the employee. (Prop. Treas. Reg. § 1.89(k), Q&A 4(b)(2)(iii)(B).)

Although I have the greatest respect for the attorneys who staff the IRS Office of Chief Counsel, I question whether it is wise to transfer broad regulatory authority over the design and content of the nation's health programs to them. As the proposed section 89 regulations demonstrate, there are some matters too important to be left to the regulators.

The Chamber therefore recommends that the five requirements and the 34 percent penalty for not satisfying these requirements be eliminated. The requirements that the plan be for the exclusive benefit of employees and that the employer have an intention to maintain the plan for an indefinite period of time serve no meaningful purpose other than imposing yet another layer of complexity on employers seeking to understand and obey the rules. The requirements of a written and legally enforceable plan document and of reasonable notice to employees are already contained in the Employee Retirement Income Security Act (ERISA). No convincing reason has been advanced for duplicating these ERISA requirements under the Internal Revenue Code and for imposing a severe new excise tax penalty on top of the penalties and remedies presently provided under ERISA.

If the Committee votes to retain these requirements under the Internal Revenue Code, then (1) the authority of the IRS to embellish the requirements via regulation should be strictly limited by the statute or by pertinent legislative history, (2) an employer should have the opportunity to cure without penalty any defects in the plan that are not the result of negligence, and (3) the excise tax should be reduced to no more than 5%. Under the Internal Revenue Code an underpayment of tax due to negligence is subject to a penalty of only 5%. (I.R.C. § 6653(a)(1).) It is simply unfair to subject an employer who inadvertently fails to amend a plan document to take some new plan feature into account to a penalty of 34% on the total amount of benefits provided under the plan.

IV Collectively Bargained Plans

The provision of the bill that requires separate testing of collectively bargained plans is an improvement over current law, but not for all employers. Employers have only partial control, and sometimes virtually no control, over the benefits paid under a collective bargaining agreement. There are many instances in which collective bargaining considerations might result in unionized employees receiving more health benefits or fewer health benefits than employees not covered by the collective bargaining agreement. Separate testing solves this problem to some extent. However, separate testing is not appropriate in all circumstances. For some employers, substantially all rank and file employees may be covered by collective bargaining agreements. In that situation employers may need to count the union employees in order for their non-union plans to satisfy the nondiscrimination requirements.

The only rule that will be workable for the majority of employers is one that allows an employer the option of excluding employees from testing whenever they have bargained collectively over health benefits. The collective bargaining process provides ample protection against discrimination for the employees covered by the collective bargaining agreement. If an employer can satisfy the nondiscrimination requirements without taking these employees into consideration, the goal of simplification is advanced by freeing the employer from the requirement of collecting data with respect to employees covered by the union plan. On the other hand, if the employer needs to take the unionized employees into account and is in a position and is willing to incur the cost of collecting the necessary data to show that the employer's health plans are nondiscriminatory when union members are taken into account, the employer should have that option.

V Multiemployer Plans

Regardless of how the Committee decides to deal with collectively bargained plans in general, there is a certain category of collectively bargained plans that cries out for attention. These are the multiemployer plans covered by the Taft-Hartley Act. Under these plans, an employer negotiates with a union over the dollar amount that will be contributed to the multiemployer plan for each hour a covered employee works for that employer. The employer does not bargain over, and does not know, how his contribution will be divided between health and other benefits. The allocation of the employer's contribution between health and other benefits, the selection of the health benefits that will be provided, and the administration of the health plan are all under the control of the multiemployer plan trustees, who in turn are subject to regulation by the Department of Labor. An employer whose employees are covered by a multiemployer plan will find it extremely difficult or impossible to collect the necessary data concerning the amount and type of coverage received by the employees and will have no means of ensuring that the multiemployer plan trustees administer the plan in accordance with section 89. As with other collectively bargained plans, the only solution for multiemployer plans that is truly workable is an option to exclude employees covered by multiemployer plans from testing. The reasons for excluding union employees are especially persuasive in the multiemployer context.

VI Other Concerns

The foregoing represent the Chamber's principal concerns with H.R. 1864. I have attempted to outline some alternatives to the provisions in H.R. 1864 that we believe will achieve the Chairman's twin objectives of nondiscrimination and simplification. There are certain other provisions of the bill that do not necessarily render the bill unworkable, but do require the Committee's attention.

Under section 89, as presently written, an employer may test employees in different lines of business separately. This is an important provision, which recognizes that competition in different lines of business may provide limits on what benefits an employer can reasonably be expected to offer his employees. However, current law imposes an arbitrary floor of 50 on the number of employees that is required to constitute a separate line of business. This floor has no justification and creates real problems, particularly for employers who are just beginning to enter a new line of business. H.R. 1864 fails to correct this problem. The 50-employee floor should be eliminated.

The application of section 89 to leased employees is only partially addressed in H.R. 1864. The proposed safe harbor for leased employees who receive core health coverage from the leasing organization is essential if leased employers are tested under section 89. However, the Service's proposed regulations on leased employees are a veritable jungle of confusion and controversy. The Service has proposed to define leased employees so broadly that many independent contractors and subcontractors would be treated as "employee leasing organizations." Until a reliable and accurate definition of leased employees can be promulgated by statute or by regulation, the Chamber recommends that the application of section 89 be limited to common-law employees of the benefit plan sponsor.

There is one provision in H.R. 1864 that is not included in current-law section 89. H.R. 1864 would treat employee contributions under a cafeteria plan, so-called "salary reductions", differently when made by highly compensated employees than when made by rank and file employees. Salary reductions by the highly paid are treated as employer-provided benefits, while salary reductions by the rank and file are not. As a result of this provision, a health plan that provided exactly the same health benefits to the highly paid and the non-highly paid and required exactly the same contribution for all employees could be treated as discriminatory. This is a change from current law that seems to have no effect other than to take away the tax benefits of a cafeteria plan from highly paid employees. This new rule on salary reductions has nothing to do with nondiscrimination and should be eliminated.

On behalf of the Chamber, I wish to thank the members of this Committee for their attention to our testimony. We look forward to working with the Committee and its staff in implementing these and other recommendations.

Mr. PICKLE. Thank you, Mr. Alexander, for your suggestions.
Now, Mr. Fay.

STATEMENT OF ROBERT B. FAY, TREASURER, AND CHAIRMAN, FRINGE BENEFIT TASK FORCE, ASSOCIATED GENERAL CONTRACTORS OF AMERICA, AND PRESIDENT AND TREASURER, JOSEPH B. FAY CO., PITTSBURGH, PA

Mr. FAY. Thank you. My name is Bob Fay. I am the president of Joseph B. Fay Co., a general contracting company from Pittsburgh, PA. I am also the AGC treasurer and appear on behalf of the Associated General Contractors of America.

AGC supports the proposal to delay implementation of section 89 until the many serious problems already identified with the new rules can be resolved. If those issues cannot be resolved, AGC supports repeal of the 1986 act changes.

AGC would like to express its appreciation to the chairman and to the committee for the many helpful changes contained in H.R. 1864. This bill recognizes many of the serious concerns of businesses in every sector of the economy. In particular, AGC commends H.R. 1864 for its shift in emphasis from plan participation to plan design, the elimination of the need to test different options, and the emphasis on cost rather than valuation of benefits.

The problem with section 89 as it exists now is its complexity. Especially for smaller companies, the cost of testing is greater than the cost of providing benefits to employees.

Companies who were trying to comply found themselves forced to streamline plans and reduce the options available to employees in order to bring the testing process down to manageable proportions.

AGC believes section 89's goals can be achieved in a much simpler manner and without diverting resources from productive investments to unproductive consultants' fees.

Other witnesses have discussed issues related to the eligibility and benefit tests. I would like to discuss special problems relating to multiemployer plans, the leased employee rules, and the problems relating to Davis-Bacon.

H.R. 1864 would provide that union employees are tested separately. Employer contributions would be used to measure compliance. Half of all multiemployer plans cover some category of construction workers.

In meeting with other multiemployer representative industries using employees in collective bargaining, AGC identified some common problems for Congress to consider. In multiemployer benefit plans, two or more employers contribute to a pooled fund on behalf of that part of their work force covered by the contract. That contract is agreed to through a collective-bargaining process between employer and labor representatives who bargain over the dollars and cents contribution based on hours worked. Individual contributing employers are then made aware of and contribute at those levels to the pool. The plan is overseen by joint trustees of labor and management who set overall policy. Day-to-day decisions are made by a plan administrator.

Individual contributing employers exercise no control over the plan benefit design, level of contributions, health benefits, or different options under the plan. Those decisions are the responsibility of the joint labor/management trustees or, in some cases, the designated collective-bargaining agent. In some cases, the plan trustees are permitted to shift dollars between funds as they believe necessary, or reserve a small percentage of the fringe benefit contributions for unforeseen problems.

The employer may contribute the same rate for each worker, but the total contribution for each worker will vary according to the hours worked. In construction, the worker may leave and return to the same employer several times in the course of a year and in any given project. That affects the total contributions, even though the worker has had health coverage in force the entire year.

At the same time, the individual employer is paying for health care coverage for large numbers of nonhighly compensated employees.

AGC would like to offer several alternatives. First, the responsibility for section 89 compliance and sanctions should be placed on the persons responsible for the plan. That approach already exists in COBRA.

Second, compliance should be based on the plan contribution rate not the contribution. If the rates are nondiscriminatory, the employer has satisfied his responsibility.

Third, an individual contributing employer whose work force consists of 90 percent or more employees who participate in one or more collective-bargaining plans and who receive health benefits should be deemed to satisfy section 89 for its entire work force. This follows the general approach of H.R. 1864, which tests for compliance across the work force.

H.R. 1864 provides leased employees safe harbor similar to the rules for the pension. The safe harbor would work if there were clearer definitions of leased employees.

The Treasury Department has already acknowledged the many flaws that exist in the proposed regulations. The IRS has interpreted employee leasing to cover the project owner—general contractor—subcontractor relationship. Leased employees should not be included in section 89 until the many serious definitional problems identified are resolved.

The Davis-Bacon Act was passed by Congress in 1931. It required that construction laborers and mechanics receive the "prevailing" wages and fringe benefits on Federal and federally assisted projects. The Labor Department set specific dollar amounts that must be paid.

The Davis-Bacon Act already encourages constructors and contractors to offer health benefits. H.R. 1864 does not address existing conflicts with the act. It exacerbates the problem.

The Davis-Bacon Act applies to both union and nonunion companies. The Labor Department takes the place of the collective-bargaining process. Davis-Bacon Act plans should be given the same status as multiemployer plans.

This concludes my remarks, and AGC would be happy to work with Congress on this most important issue. Thank you.

[The statement of Mr. Fay follows:]

Testimony of

The Associated General Contractors of America

Good afternoon. I am Robert B. Fay, President and Treasurer of Joseph B. Fay Co., a construction company based in Pittsburgh, Pennsylvania specializing in municipal utility, highway and building construction. I am also the treasurer and appear on behalf of the Associated General Contractors of America.

The Associated General Contractors of America is a construction trade association representing more than 32,500 firms, including 8,000 of America's leading general contracting companies, which are responsible for the employment of more than 3,500,000 individuals. These member construction contractors perform more than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities. Eighty-five percent of AGC's membership has gross receipts of less than $10 million annually; ninety percent qualifies under the Small Business Administration's definition of a small business. AGC appreciates this opportunity to comment on HR 1864, the proposal to reform Section 89.

AGC urges that, in considering these comments, Congress keep in mind the unique nature of the construction industry, as follows:

- The construction industry produces a unique item with every building, facility or highway constructed. Every blueprint is different; each site varies; conditions for construction vary every day.

- The construction industry does its work at multi-thousands of jobsites, resulting in a largely transient workforce.

- The construction industry's transient workers must regularly move to new sites and normally another employer to continue working.

- A construction worker may leave and come back to the same employer several times in the course of one year, as projects begin, go through the phases of construction and end.

In the construction industry, we offer a wide variety of health plans to suit the unique needs of our hourly workers.

Congress clearly recognizes the serious problems Section 89 poses for every segment of American industry, reflected as follows:

- Rep. LaFalce's bill to repeal Section 89 has nearly 300 cosponsors.

- Rep. Philip Crane of this Committee introduced legislation.

- In addition, a number of senators have expressed their support for repeal or delay of Section 89.

From the perspective of the construction industry alone, Section 89 as it now exists is so badly flawed in so many ways that AGC strongly supports Rep. LaFalce's bill to repeal it. If the many serious problems already identified with the statute cannot be quickly resolved, AGC supports repeal of the 1986 act changes and return to the pre-1986 nondiscrimination rules. No penalties should be imposed for failure to comply with Section 89 in 1989, because of the many uncertainties surrounding this issue.

AGC would like to express its appreciation to the Chairman and to the Committee for the many helpful changes contained in H.R. 1864. This bill recognizes many of the serious concerns expressed by businessses in every sector of the economy. In particular, AGC commends HR 1864 for its shift in emphasis from plan participation to plan design, the shift in emphasis to core health coverage, the elimination of the need to test different plan options and the emphasis on cost rather than valuation of benefits.

Section 89 as it now exists does not further Congress' goal of encouraging broader coverage of nonhighly compensated workers. Instead, its complexity and administrative problems force employers to reduce the number of options they offer to employees.

The problem with Section 89 as it exists now is its bewildering complexity. Section 89 requires that every option offered under every plan be valued separately. For each option, every employee must be ranked twice, once under this year's salary and once under last year's salary, to determine how many highly compensated employees participate in that option. Especially for smaller companies, the cost of testing is greater than the cost of providing benefits to employees. Most smaller companies do not have staff in-house with the expertise necessary to perform the complicated testing. They must hire expensive outside consultants.

Companies trying to comply found themselves forced to streamline plans and reduce the options available to employees in order to bring the testing process down to manageable proportions. Plans developed to cover a highly mobile workforce in physically demanding jobs are in danger of being terminated for failure to satisfy technical tax rules.

The regulations that were issued by the IRS in March added additional complexity to the testing process. They exacerbated the problem, rather than providing helpful guidance.

AGC believes the goals of Section 89 can be achieved in a much simpler manner without forcing small businesses to divert resources from productive investments to consultants' fees.

AGC would like to take this opportunity to offer some insights into special problems and to offer some alternatives as solutions.

Multiemployer plans. Half of all multiemployer plans are in the construction industry. In meetings with other multiemployer representatives and industries using employees in collective bargaining units, AGC identified some common problems for the Congress' considerations. To understand the problems, it is necessary to examine the nature of multiemployer benefit plans.

Multiemployer benefit plans are common in labor-intensive industries where employees shift from employer to employer within a geographic region. Two or more employers will contribute to a pooled fund on behalf of that part of their workforce covered by a particular contract. The contract is agreed to through a collective bargaining process between representatives of the employers and labor representatives. These multiemployer benefit plans provide various combinations of health, welfare and retirement benefits.

Multiemployer funds are subject to the Taft-Hartley Act and Labor Department regulations. The plans are overseen by joint trustees of labor and management, who set overall policy. Day-to-day decisions are made by a plan administrator.

In the collective bargaining process, employer and employee representatives bargain over the dollar-and-cents contribution based per hours worked. Individual contributing employers are made aware of and contribute that level into the pooled fund. The allocation of the total contributions into various options is the responsibility of the joint labor and management plan trustees.

Individual contributing employers exercise no control over plan benefit design, level of contributions, or health or other benefits and different options within plans. Such decisions are the exclusive responsibility of either the plan trustees or, in some cases, the designated collective bargaining agents. In some cases, plan trustees are even permitted to shift dollars between funds as they deem necessary or reserve a small percentage of the fringe benefit contributions for unforeseen problems in the various funds. Individual contributing employers do not process employee claims for health benefits. Those are processed by the plan offices.

In industries where multiemployer plans are common, the work is labor-intensive and the need for workers shifts from day to day within a geographic area. The overall workforce remains numerically stable. Workers leave and return to one employer several times in the course of the year, as the need for workers at particular projects shifts.

H.R. 1864 would provide that collectively-bargained plans are tested separately. As can be seen from the preceding description, there are several problems with that approach.

Individual contributing employers have no control over plan design, options or benefits. Individual contributing employers do not know what benefits are paid out to employees. It is typical in multiemployer plan situations that the workforce fluctuates substantially from day to day from employer to employer. The individual contributing employer may contribute the same rate for each worker, but the contribution total for each worker will vary according to the number of hours worked. The worker may leave and return to the same employer several times in the course of the year and that will affect the total contributions, even though the worker has maintained his or her health coverage throughout.

At the same time, the individual contributing employer is paying for health care coverage for large numbers of nonhighly compensated workers. As this is one of the goals of all nondiscrimination proposals, the problem should be addressed. AGC would like to offer several alternatives.

First, the responsibility and sanctions should be placed upon the person or persons responsible for the plan. The appropriate approach is outlined in COBRA. For single employer plans, the employer is responsible. For multiemployer plans, the plan is responsible. Because the plan trustees are responsible for plan design, it should be their obligation to design the plans in a manner that satisfies the Section 89 requirements.

Second, the applicable comparison should be the contribution rate of the individual employer, not the contribution. The total contributions are affected by the number of hours worked. The employer has no control over how contributions are spent. He or she bargains for the hourly contribution. As long as the rates are not discriminatory, the employer has satisfied its responsibilities.

Third, an individual contributing employer whose workforce consisted of 90% or more employees who participate in one or more collectively bargained plans and who receive health benefits that are the subject of good-faith bargaining could be deemed to satisfy Section 89 for its entire workforce. This follows the general approach of H.R. 1864 which requires that coverage be available to 90% of the nonhighly compensated workers. If that many workers are actually covered, the employer has met its obligations. The plan administrators, as the parties responsible for plan design, would test the plans for eligibility and benefits.

Leased employees. H.R. 1864 provides a leased employee safe harbor similar to the rules for qualified pension plans. Under the bill, an employer may disregard a leased employee if the leasing company certifies that the employee has available a core health plan meeting the limitations on employee contributions. This rule may be used only if leased employees do not constitute more than 20% of the employer's nonhighly compensated workforce.

AGC and other organizations have identified several severe problems with the leased employee rules in the pension area. The Treasury Department has acknowledged that the proposed regulations are too broadly written. Section 89 reform should not import those problems from the pension area that are in the process of being redressed.

Employee leasing is an employment arrangement under which a "leasing organization" leases individual workers that it employs to a "service recipient" for whom the "leased employee" performs services. The leased employee is an employee of the leasing organization. The leasing organization pays the employer's wages, withholds tax and performs the other normal administrative duties of an employer. The service recipient is a business or employer that pays a fee to the leasing organization that covers the employee's wages and the fees of the leasing organization.

In 1982, Congress passed IRC Section 414(n) to prevent the employee leasing rules from being abused. However, the IRS has issued proposed regulations that would define employee leasing far more broadly than Congress intended. Under the proposed rules, services would be "historically performed" if it is "not unusual" for employees to perform the services in the United States. The "substantially full-time" rule is satisfied if the person has performed 75% of the hours similarly positioned employers perform in one 12-month period.

These and the other proposed rules are written so broadly, they are being treated as covering independent contractors and subcontractors as well as leasing organizations. The proposed regulations would require the subcontractor's employees to be treated as employees of the general contractor for benefit plan purposes. If followed to their logical end, project owners would be required to pay benefits for the employees of the general contractors as well as the subcontractors.

Subcontractors and general contractors are independent businesses. They incur the expenses, and take the risk of profit and loss. Subcontractors normally provide health and retirement benefits to their employees, but H.R. 1864 as presently written does not recognize that. If subcontractors are deemed to be leasing organizations, then more than 20% of the general contractor's workforce would be regarded as leased employees and the safe harbor rules would not apply.

There is also a hidden trap in the plan qualification rules as they relate to the leased employee rules. On a construction site, one general contractor works with multiple subcontractor companies. For example, on a commercial building site, the general contractor can have up to 75 subcontracting companies on that one site during the life of the contract.

If the subcontractor's employees are to be treated as the general contractor's employees for Section 89 purposes, then the subcontractor's employees will have to be notified of the general contractor's health plans. If the subcontractor's employees are not to be treated as the general contractor's employees, then including them may cause the plan to fail Sec. 89 because the plans are not for the exclusive benefit of employees. The general contractor may be caught in an impossible situation.

If general contractors are too broadly inclusive, they may fail that part of the qualification test. If they aren't inclusive enough, they will fail a different part of Section 89. If the construction contractor doesn't provide notice of the plans to the subcontractors, he may fail the qualification requirements if the IRS later determines it should have been done. The subcontractors are not required to supply any information to the general contractor or the employees on the job-sites. The subcontractors, because they are treated as the leasing organization, are not compelled to provide information for compliance testing to the general contractor. The general contractor may supply Section 89 information to the subcontractors, but there is no mechanism for ensuring that the actual employer, that is the subcontractors, supply the necessary information to the on-site employees.

The safe harbor rules could be reexamined. The goal of Section 89 is to make sure that nonhighly compensated employees are covered. If the employees are receiving core health coverage, does it make a difference where the coverage is coming from?

Better clarification of the leased employee rules is essential, given the severe tax penalties imposed on employers for failure to comply with plan qualification requirements. Given that the Treausry Department has acknowledged the flaws in the proposed regulations, we suggest that leased employees be held in abeyance for Section 89 purposes until the many serious problems already identified can be resolved.

Davis-Bacon Act considerations. The Davis-Bacon Act, passed by Congress in 1931, requires that hourly construction laborers and mechanics receive the "prevailing" wages and fringe benefits in a locality on federal and federally-assisted construction projects. The Labor Department conducts surveys and sets the dollar amounts to be paid to laborers and mechanics. The Act applies to both union and non-union workers. H.R. 1864 would have the effect of taxing benefits another federal statute requires employers to pay.

The Labor Department studies local conditions and other statutes to determine what wages and fringe benefits prevail in states, cities or counties. They then issue a general wage determination decision that specifies in dollars and cents the minimum amounts to be paid by contractors and subcontractors to laborers and mechanics. Part of the wage decision is labeled "fringe benefits" and that amount may be used to provide health and retirement benefits. The Davis-Bacon Act requirements may be satisfied if the employee receives the entire amount - both wages and fringe benefits - immediately in cash. If the employer provides health or retirement benefits instead of cash, stringent Labor Department requirements must be met.

Suppose the employer satisfies the Davis-Bacon Act requirements by paying cash. The employees receive their benefits, but not in a format that would satisfy H.R. 1864 as currently written. The employer would have to provide two sets of benefits to satisfy the two statutes. Under Davis-Bacon, there must be the option to pay cash to satisfy the employer's obligations to pay cash due to the requirements of the Act.

Suppose the employer applies the Davis-Bacon fringe benefit amounts to pay for health insurance. The employer would provide core health coverage to a large number of hourly construction workers. Construction workers leave and come back several times a year to the same employer. It would be difficult to determine whether the H.R. 1864 requirements are satisfied, even though the employer is providing federally mandated benefits. The amounts specified by the Labor Department general wage determination decisions do not match the dollar amounts in H.R. 1864. Davis-Bacon amounts may not be used to fund benefits not related to Davis-Bacon work.

The Davis-Bacon Act is analogous to the collective-bargaining process. A federal statute takes the place of the negotiated agreements. Indeed, Davis-Bacon applies to both union and non-union employers. The Labor Department determines the wage and fringe benefit rates for all federal and federally-assisted construction. A federal statute should be given at least the same status as a negotiated contract. Davis-Bacon amounts and workers should be given the same status as collectively-bargained agreements and workers.

Plan qualification requirements. H.R. 1864 essentially adopts the plan qualification requirements contained in Section 89. In addition to the problems outlined above with respect to leased employees, AGC has identified several other problems in the plan qualification area. The problems in the plan qualification area are particularly important because the sanctions for violating them are so severe.

Under HR 1864, employers must satisfy a five-part qualification test for group health plans, group term life insurance plans, qualified tuition reduction assistance plans, cafeteria plans, Section 505 plans (including VEBAs), and employee fringe benefit plans.

For each of these plans, the plan must be in writing, the employees' rights must be legally enforceable, employees must be given reasonable notification of benefits, the plan must be established for the exclusive benefit of the employees, spouses and dependents, and the plan must be established with the intention of maintaining it for an indefinite period of time. These requirements are even more difficult to meet than they sound.

For example, after the 1988 act, the written material describing the plan may be a group of documents, as long as each plan is adequately described in writing. The proposed regulations contain a long list of material terms that must be included in the description. There must be one document that includes the information, incorporates other documents by reference or combines both approaches.

The proposed regulations add additional complexity without much gain to the employee and at an increased cost to the employer. The statute should be amended to coordinate the rules with COBRA and ERISA requirements.

For example, the material terms cited by the regulations that must be provided to employees are very close to the requirements for summary plan descriptions prescribed by the Labor Department. Why not have one be the same as the other? The summary plan description is already distributed to plan participants. There is no benefit to the employees in providing two sets of notices. The notice of material changes to the plans must be distributed within 60 days to all eligible individuals. Under ERISA, a summary of plan changes must be distributed within 210 days after the close of the plan year. Again, the proposed regulations impose additional unnecessary and repetitious notice requirements. It is at least an arguable issue whether IRS has the authority to override ERISA requirements.

Those plan documents must be legally enforceable. The employees' rights must be ascertainable from the documents, so that legal remedies can be pursued based on the documents. So those documents must be carefully prepared with that in mind. There is insufficient guidance available as to what constitutes legally enforceable, yet failure to satisfy this requirement would trigger stiff sanctions against the employer.

Employees must receive reasonable notification of their benefits under the plan. What constitutes reasonable notification? The answer seems to be that every employee must be notified of every benefit under every plan, in order to avoid Section 89 penalties. Notification may not be limited to employees who are eligible for a particular benefit. Employees who may become eligible in the future must also be notified. With an annual turnover of 300%, the notice requirements in the construction industry will become repetitious, burdensome and expensive to the point that construction contractors will be forced to withdraw benefits.

When COBRA was enacted, it was quickly seen how unnecessary those notice requirements were. The problems will be geometrically more complicated under Section 89. The lessons learned from COBRA should be implemented in Section 89.

Sanctions. The sanctions for failure to satisfy the qualification requirements need additional revisions. There are many uncertainties and unresolved issues in Section 89, whether as it exists now or with the changes contemplated by H.R. 1864. Employers making good-faith efforts to comply could be hit with unwarranted and severe tax penalties. This is particularly true in light of the lack of guidance from the IRS on crucial issues.

First, no penalties should be applied this year. All penalties should be delayed until plan years beginning in 1990. With the great uncertainties surrounding Section 89 at this point, it is unfair to penalize employers.

Second, penalties should be applied to the person or persons responsible for the failure to comply. For single employer plans, the employer should be responsible. For multiemployer plans, the plan should be responsible.

Third, the sanctions should be simplified. Taxing the employers on benefits paid is onerous and capricious in its impact. Two employers may have the exact same fault in their plans. If one employer has an employee who had a heart attack, that employer is penalized much more severely. If a plan fails the qualification requirements, the penalties should be the same as failing the eligibility and benefits testing. There is no rationale for having a separate penalty.

90% available coverage. The 90% available coverage test is set too high. This is another instance where the statute should be coordinated with other statutes. ERISA requires 70% coverage. The minimum coverage rules in IRC Section 410 require 70% coverage in the pension area. The threshold test for Section 89 purposes should also be set at 70%.

The employment relationship in the construction industry is unique for several reasons. Unlike any other industry, construction companies are faced with constantly shifting jobsites and constantly shifting workforces. Given the phased nature of the construction process, the work force changes as the job progresses. For example, on a commercial building, the electricians may come in, work on several floors, move to another job site to do work there, then come back and work on additional floors and so on until the building is finished.

Once the building is finished, construction workers do not have the choice of staying at the site. They must move on to another jobsite and normally another employer if they want to continue working. That is why the construction industry has a turnover rate of 300%. This creates tremendous uncertainty as to whether a plan will remain in compliance.

The tax-favored treatment of employer-provided employee benefits furthers an important social goal of expanding health care coverage. Section 89 as rewritten by the 1986 tax act had the opposite effect. The problems outlined above support the position AGC has taken on repeal of Section 89. Implementation of the statute should be postponed until the many serious problems already identified can be resolved.

Meanwhile we are obliged to again emphasize that Section 89 as rewritten by the 1986 tax act is having and will continue to have a disastrous impact on the construction industry alone. Faced with the complexities, contradictions and numerous flaws in Section 89, construction contractors, the overwhelming majority of which are small, family-owned businesses and facing the economic realities that Section 89 fails to recognize will be obliged to discontinue benefits, the provision of which is so seriously jeopardized by a Section 89 so flawed that its repeal is widely supported.

AGC appreciates this opportunity to review some special problems and looks forward to working with the Committee and with Congress to resolve these problems.

Chairman Rostenkowski. Thank you, Mr. Fay.

Mr. Gardner.

STATEMENT OF JAMES H. GARDNER, PRESIDENT, RISK MANAGEMENT RESOURCES, INC., SAN FRANCISCO, CA, ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. Gardner. Thank you, Mr. Chairman.

My name is Jay Gardner, and I am testifying this morning as a California small businessman and also as a representative of the more than 570,000 business owners who belong to the National Federation of Independent Business [NFIB].

We would like to begin by saying that we think sincerely that your bill represents a major step forward in easing the substantial burdens of compliance that small businesses have to confront with existing law. We come to you today in the spirit of the speech when you introduced the bill of looking for suggestions on how to make this better.

Our members do not believe in discrimination. We are not in favor of discrimination; we do not believe that the highly compensated employees or their families deserve better health care benefits than those of workers in general. We support the provision of health care benefits by employers on a voluntary basis and as the economic circumstances of their business allow. In fact, over three-quarters of our membership provides such coverage.

Those that do not provide it do not fail to do so because they are greedy or because they are philosophically opposed. Many of them have to choose between providing employer-subsidized health care and employment, which brings me to the primary concern that we have with the approach that this bill is taking.

For all the complexity that existing law has, it never asserts that in order for a plan to be nondiscriminatory that the cost of coverage must be highly subsidized. H.R. 1864 makes that substantial leap and provides that the price to the employer community of fairness and understandability in testing for discrimination is a concurrent requirement that they pay a major portion of employee health care costs. We reject this approach.

Nondiscrimination, it seems to us, must only mean provision of reasonably comparable benefits and subsidies to highly compensated and nonhighly compensated employees alike. A mandating of how much of the cost an employer should pay is the subject of a separate discussion, and a very complicated discussion, I might add, which involves many issues which are beyond the scope of what we are talking about this afternoon.

Before I leave the subject of subsidies, however, I would like to just touch on a couple things, because I know the subject will not go away. You have proposed a dollar-limit approach. Other witnesses here this morning have suggested a percentage approach. I would like to suggest a third possible approach as an alternative to the other two; that is, a test based on a percentage of pretax profits of the employer.

Your bill gives ample consideration to affordability on behalf of the employee. It assumes affordability on behalf of the employer.

In fact, many employers just cannot afford to subsidize at the levels that you proposed.

The next major issue that we would like to address is that of the definition of highly compensated employees. Although we know it was not the intent of the bill, as things are currently constructed, the bill is highly discriminatory against small business. Relief is provided for certain organizations which have no highly compensated employees, such as local governments, but no relief at all is provided for the small business person who, to be sure, owns the business but by no measure can be considered to be highly compensated.

Frankly, the assumption is made that if you own a business you must be rich, and nothing could be further from the truth. The median income of the self-employed in the United States is substantially under $30,000 a year. We are talking about your shopkeepers, your service station operators, your barbers. These people are, after all, main street America, and they are no more able to pay the high cost of health care than their employees are; in some cases, less able. Yet under existing law and under this bill H.R. 1864, they are regarded as being highly compensated.

How can we expect small business owners to understand that the employee of a large corporation, who may earn several times what they do, is not considered to be highly compensated, and yet they are? Fairness demands that the test of being highly compensated be the receipt of high compensation, and there really is no other appropriate measure.

I am going to leave other specific points to the testimony of others, but with our general philosophical support. We are concerned about the effect of this bill on salary reduction and cafeteria benefits plans, because in increasing numbers they are becoming a way for small business to stick their toe in the water of providing, beginning to provide health insurance in the case of those employers who do not.

Finally, I would like to state just one general proposition about this act, and some others that are running around the State legislatures and in the Houses of Congress. The fundamental issue is that health insurance in the United States has become unaffordable. It has become unaffordable for employees; it has become unaffordable for employers. And why? The why is very simple: because health care has become unaffordable.

Until we deal with that issue, until we step up to the problem instead of the symptoms, I think we will not achieve a shared goal of providing broadly based access to health care for all Americans.

Thank you very much.

[The statement of Mr. Gardner follows:]

NFIB

National Federation of
Independent Business

SUBMITTED STATEMENT OF

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: House Ways & Means Committee

Subject: H.R. 1864

Date: May 2, 1989

Mr. Chairman, on behalf of the more than one half million small business owner members of the National Federation of Independent Business (NFIB), I am pleased to submit this statement of our members' concerns with Section 89 of the Internal Revenue Code and our suggestions for modifying H.R. 1864.

Mr. Chairman, NFIB applauds your introduction of H.R. 1864 as a major step toward correcting many of the most troublesome and unmanageable aspects of Section 89. We believe it can be improved in a number of ways.

We also believe it leaves unresolved a number of important health care policy issues, such as, will Section 89 non-discrimination rules in fact increase health insurance coverage among rank and file employees? We are uncertain, but very dubious, at least as it applies to the employees of small businesses, that it will.

At the moment, NFIB's members strongly support the repeal of Section 89. They are concerned that it will negatively affect their ability to expand health insurance coverage to their employees. Growing labor market shortages are pushing small business owners to expand wage and benefit packages in order to attract and keep quality employees, but they are concerned that compliance with Section 89 will divert scarce resources which could be spent on health insurance benefits. They are also concerned that Section 89 will result in a reduction in insurance coverage being offered.

One of the reasons small business owners favor repeal of Section 89 over other solutions is a strong feeling that its only real policy objective is the taxation of fringe benefits. Or even worse, as nothing more than a blatant revenue raising device.

It seems to us that the Congress is on the very sharp horns of a dilemma. H.R. 1864 and constructive modifications of it will be relatively simple but rigid. Being rigid, this solution will, in all likelihood, not be able to accommodate all of the choices in the health insurance marketplace, and will do nothing to increase health insurance coverage among rank and file employees.

On the other hand, the current Section 89, which is relatively flexible, is extremely complex -- so complex and so punitive that employers are already dropping health insurance programs.

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Unfortunately, neither Section 89 nor H.R. 1864 are effective solutions in the health policy area. From NFIB's perspective it appears that the important public policy objectives of Section 89 are in fact best accomplished by returning to pre-1986 tax law.

With the introduction of H.R. 1864 and the scheduling of these hearings on those in the Senate Finance Committee on May 9, it appears reasonable to believe that Congress is ready to deal with the dilemma created by Section 89. Unfortunately, businesses, especially those on Main Street, across the country are agonizing over confusing and costly decisions revolving around compliance. To eliminate this confusion and preserve scarce resources, we believe that whatever the outcome of this debate, the effective date of current Section 89 should be delayed or suspended at least until the beginning of 1990.

POLICY BACKGROUND AND ISSUES

Section 89 of the IRC was a part of the Tax Reform Act of 1986. The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985) discussed the reasons for tax reform. Under the heading of "the system is too complicated" is stated:

> For some [taxpayers], it seems a difficult -- and sometimes even ridiculous -- administrative burden (emphasis added).
>
> Efforts to increase compliance within the framework of the current system seem not only to have reached the point of diminishing returns. They often seem to be counter-productive: They increase resentment and disrespect for a system that cannot long function without a firm foundation of public confidence.

Unfortunately the President then went on (in Chap 3, part A) to propose complicated and counterproductive non-discrimination rules for employer-provided health insurance and other fringe benefits. Without thoughtful analysis of affects, appropriateness, or costs, this proposal became the genesis of the monster created in Section 89.

The heart of the problem lies in proposals that attempt to extend ERISA's non-discrimination rules to other fringe benefits. Because insurance and pension plans are completely different products, facing entirely different market forces, the application of ERISA rules to both simply doesn't work. In fact, Section 89 clearly proves that this attempt was counterproductive.

Providing tax incentives to employers to encourage them to provide health insurance to their employees is an example of public policy that has worked. Eighty five percent (85%) of the American population is now covered by health insurance -- most of it provided by employers -- up from 40% in 1940. It is a more widely used incentive than the home mortgage interest deduction.

Employer provided health insurance has become a cherished fringe benefit, second only to paid vacations. The tax incentive that has encouraged this expansion of coverage should be viewed at least as "sacrosanct and, to quote President Regan's proposal further, as "central to American values" as those incentives for home mortgages, disabled veterans, and charitable contributions.

Section 89 purports to be an effort to increase health insurance coverage among the working poor and to eliminate alleged abuse of the tax code by employers who give themselves and their highly-compensated employees better fringe benefits than their non-highly-compensated employees. The first goal, expansion of coverage, certainly will not be accomplished by adding a new hurdle to offering employee health insurance. The second goal appears to us to be based on an unfounded assumption of widespread abuse. Trying to achieve it could be an exercise in diminishing returns, dramatically decreasing the chances of reaching the first.

The working poor don't have health insurance for a lot of reasons, but employer discrimination does not appear to be one. The competition and mobility in the labor markets of today work powerfully against discrimination. The majority of these employees don't have health insurance because they either choose not to purchase it or because their employers cannot afford to provide it. Section 89 only adds to the problem of affordability, and any variation on the current Section 89 will do the same.

As for the alleged problem of excessive benefits for the highly compensated, where is the evidence? And wouldn't some form of "facts and circumstances" test be a more flexible, productive manner of trying to get at that which may exist, rather than a "one size fits all" policy? Is the next step in tax policy to extend Section 89 nondiscrimination rules to "wages and salaries" in order to "even out" the tax benefits of income?

According to the Joint Committee on Taxation, the tax revenues to be raised by Section 89 were to be $72 million in 1988, $128 million in 1989, $140 million in 1990, and $154 million in 1991, or a total of $494 million over four years. The cost of the deduction for health insurance premiums is more than $30 billion: Where is the discrimination? Wouldn't we be raising much larger amounts of revenue if it were widespread and pervasive?

Section 89 is both legislative overkill and a poorly concealed attempt to extend the "comparable worth" theory to tax policy. It is blatant social engineering through the tax code and will only serve to further undermine voluntary compliance.

SMALL BUSINESS EMPLOYEE BENEFITS

Small business employers and employees are being affected by the rising cost of health insurance premiums and health care in general. Employer-sponsored group plans are popular because they afford an employee an opportunity to obtain health insurance coverage at a cost that is far lower than he could purchase as an individual.

Unfortunately the small business owner is coming under increasing financial pressure just to maintain current levels of coverage because insurance premiums are increasing 20 to 30 percent or more each year. It is no secret that small plans cannot receive the same benefit of lower cost that some larger employers can because of the economies of scale involved. These cost increases are beginning to affect the types of coverages and options an employer can provide.

The following are some of the relevant results of a major small business employee benefits study done by the NFIB Research and Education Foundation in 1985:

- Paid vacations and health insurance were the two most common employee benefits found among the nation's small businesses.

- The median monthly employer cost of voluntary employee benefits, i.e. benefits not provided by legal compulsion, was $1,450 for those providing at least one benefit. Mean or average monthly costs were twice that, pulled upward by a very few firms. Compulsory employee benefits, i.e. legally required benefits such as FICA and workers compensation, cost small business owners about as much as did voluntary benefits.

- The number of small business owners providing employee health insurance has been rising. Sixty-five percent offered health insurance coverage for at least some full time employees, an increase of eight percentage points from a similar survey conducted in 1978. Most responsible for the increase were Financial Service, Professional Service, Retail, and smaller firms.

- Well over 80% of health insurance plans offered in small firms carried an option for dependent coverage.

- The mean monthly health insurance premium paid by small employers was over $1,766, more than double the monthly premiums paid in 1978.

- Small business owners purchased private health insurance from a great variety of carriers. Self insurance (4%) and HMOs (3%) remained an oddity.

- While the firm was the group's sponsor more often than not, trade/business associations have been increasingly assuming that role. Apparently, the trend to greater association sponsorship is tied directly to increasing employee health coverage in small firms.

- Nearly two thirds of small business owners with health insurance reported they were generally satisfied with the health care plan offered their employees. That represented a seventeen percentage point drop from 1978 and can be directly related to increased insurance costs.

- Small business owners and/or a designated employee spent comparatively little time searching for health insurance alternatives, health care cost control options, etc. Outside advisors, particularly insurance agents, often substituted for owner/employee search.

- Employee health insurance was not provided by about one third of small business employers. No single reason dominated their decisions. The most frequently cited reasons were: employees generally covered under a spouse or parent policy (secondary wage earners), premiums too high, employee turnover too great, firm insufficiently profitable, and can't qualify for group policies.

The conclusions that we draw from this study are that small firms do not offer more, or any, health insurance for their employers for three primary reasons. First, many small business firms are just too marginal. Second, the kinds of employees that many small businesses hire make it difficult for them to be covered. And third, the nature of the health insurance industry prevents some firms from obtaining or affording coverage.

H.R. 1864

For a large proportion of the small business community, H.R. 1864 is a significant improvement over current Section 89 for at least the following general reasons:

-Compliance will be much less complicated and expensive;

-discrimination is based on availability, rather than on participation;

-employee and employer tax status is much more predictable; and

-the unrealistic definition of part-time work has been improved.

Notwithstanding these significant general improvements, there are a number of specific recommendations we would like to make to H.R. 1864 for its improvement. Furthermore, H.R. 1864 raises some new concerns on its own. In what follows, we have summarized our suggestions and concerns with H.R. 1864:

(1)The change in the threshold at which part-time workers must be considered for purposes of Section 89 testing is certainly an improvement over current Section 89. However, it is our belief that a 30-hour threshold would be more appropriate for two reasons. First, in many parts of the country, insurance companies will not sell health insurance for employees who work less than 30 hours per week. Second, 30 hours per week is much more in line with the economic realities and working practices of small firms. Having any lesser threshold would almost certainly cause employers to simply reduce the part-time work available in their firms to avoid having to count part-time workers in meeting H.R. 1864's 90% availability test.

(2)Tying the new availability test to a 90% rate is too restrictive. This is true especially with a 25-hour threshold for consideration. Ninety percent is also too high because it is not enough leeway to accommodate those individual situations, particularly relevant in small firms, where an insurance carrier may refuse to cover some individual because of a preexisting condition or other underwriting practices. Such situations are beyond the control of the employer, and in a small firm with less than 10 employees, the exclusion of one individual would cause the company to fail the 90% test. The majority of companies in this country employ less than 10 employees. Although not a perfect solution, we would suggest using the same percentage test as exists in testing top heavy pension plans, i.e. 70%.

(3) For maximum employee contribution, using specific dollar figures indexed to average wage growth for maximum employee contributions when the cost of health insurance is increasing so dramatically poses a problem. While the maximum employee contribution figures may be generally reasonable today, they will be totally unrealistic within 2 or 3 years. Furthermore, putting such limits on employee contributions seems to be counter to the need to improve consumer utilization of health care by having them become more aware of the costs involved. In addition, using a uniform dollar level ignores regional differences in wages and insurance costs. While no solution will solve all of these problems, an improvement would be achieved by either using a cost-based index or by substituting dollar levels with something like a percentage of total compensation.

(4) By limiting the coverage that a highly-compensated employee may exclude from income to 133% of the value of the employer-provided employee-only coverage that is taken into account in satisfying the 90% test, H.R. 1864 establishes a more stringent requirement than exists in current Section 89. Current Section 89 has a 90%/50% test, H.R. 1864's test is 80%/75%. Requiring in effect a comparison between the lowest-paid employees and the highly-compensated employees will increase the taxable income for highly-compensated employees and probably generate considerable revenues. Another possible reaction is to reduce benefits to the lowest common denominator.

(5) The definition of a highly-compensated employee has not been changed in any way helpful to a small business owner. All owners by definition in this bill are considered highly compensated, even though the average self-employed person makes substantially less than $30,000 annually. It is not clear what public policy goal is being achieved by trying to define all small business owners as highly-compensated individuals.

(6) H.R. 1864 includes the term "qualified core health plan". This term needs to be defined in the law more clearly to prevent the IRS from defining a core health plan in regulations. Citing the COBRA definition would be one such clarification.

(7) The determination of the value of employer-provided benefits should not be left up to the determination of the Secretary of the Treasury. The marketplace determines the value of various types of coverage in the price of premiums or other charges by health insurance carriers. This should be sufficient for all tax purposes.

(8) The leased employee safe harbor created by H.R. 1864 is only of use if a clear definition of "leased employees" exist. At this time no such clear definition exists, therefore the effective date of Section 89 rules as applied to leased employees should be delayed to give the Treasury Department time to development such rules and definitions.

(9) H.R. 1864 requires that if you cover any part-time or otherwise excludable employee, then all such employees must be covered and included in the determination of whether or not 90% of the firm's non-highly-compensated employees have benefits available to them. This provision appears as if it will actually reduce coverage. In small firms there are often good and humane reasons for wanting to cover usually excludable employees, for example, an

older person working part time. It does not appear as if any public policy purpose is served by requiring the full apparatus of Section 89 to apply in such cases.

(10) Under the bill cafeteria plans would be difficult or impossible to continue. Cafeteria plans are not yet a common feature of small firm compensation packages, but to the extent that they increase employee choice and possibly better utilization of health care facilities, they are an attractive option. H.R. 1864 appears to preclude that option.

(11) The qualification requirements contained in H.R. 1864 should be more precisely defined at least insofar as what "legally enforceable" and "indefinite period of time" mean. The statute should reflect in the clearest possible way that the employee is only entitled to the benefits the employer has purchased from a insurance carrier or other provider. For small employers an "indefinite period of time" means the end of the billing cycle. This requirement should either be dropped altogether or defined in some reasonably understandable manner.

(12) The 34% excise tax imposed on employers for failing to satisfy the qualification requirements is on "amounts paid or incurred during any taxable year under a specified employee benefit plan". First, this appears to be a tax based on the amount of benefits paid rather than on premiums paid. This could be a potential disaster for a small business if not clarified to say premiums or their equivalent. Second, the 34% rate is the same as the highest corporate rate. It is not clear why this rate was chosen, especially since there is a graduated corporate income tax rate schedule. In any case, something on the order of a 10% excise tax should be sufficient.

(13) Since small businesses are not heavily unionized, I will not dwell upon the problems H.R. 1864 causes in this regard, other than to say that if union plans and plans provided by the public sector and by tax-exempt organizations are excluded from Section 89 requirements, then there would appear to be much less of a revenue concern with the provision of employer-sponsored health insurance plans. Indeed, excluding such plans would argue that section 89 is primarily targeted toward small businesses.

CONCLUSION

H.R. 1864 is a significant improvement of current Section 89. It is dramatically less complex and much easier for small business owners to understand and comply with. It can be improved further, though, and NFIB strongly urges the Committee to consider the serious problems we have outlined, especially the dollar figures and index used in the eligibility test, and the treatment of part-time employees. A simpler, more workable approach is still possible.

Even though H.R. 1864 is a better solution than current Section 89 and can be improved further, we remain skeptical that it does anything to improve or extend coverage of health care. It will still be a new impediment and disincentive to employers, especially smaller employers, to provide health insurance. Therefore, it will reduce, if only marginally, the current government incentive in this area.

If this analysis is accurate, then both Section 89 and H.R. 1864 are little more than cleverly manufactured methods to tax employee fringe benefits. The conclusion becomes even stronger that the evidence used to prove discrimination is little more than anecdotal in nature.

H.R. 1864 may be a major improvement, especially in the areas of complexity and compliance, for most small business owners, but it will be a step backward in our efforts to expand employer-provided health insurance. It also breaks significant new ground in the taxation of employee fringe benefits. Therefore, NFIB continues to prefer and support the repeal of Section 89.

As this issue has been analyzed and debated, a number of individuals -- including Senator Heinz, a major voice on health care issues in the Senate -- have suggested that discrimination problems in the health insurance area, if they exist, can be taken care of by a simple statement or declaration by employers that they do not willfully or to their knowledge discriminate in providing this fringe benefit. Given the documentation problems with Section 89 and the potential negative effects of H.R. 1864, it may be well worthwhile for the Committee to pursue this approach.

Mr. Chairman, the introduction of your bill and these hearings are a strong signal that current Section 89 will be significantly changed. While you and your colleagues debate the final outcome of Section 89, something must be done to ease the frustration of Main Street and prevent the needless waste of scarce resources on needless compliance. NFIB urges you to join with Senator Bentsen and Secretary Brady to find some way to suspend enforcement of the current law until the changes you will enact can be put in place.

ADDENDUM

SMALL BUSINESS REACTIONS TO SECTION 89

Health Care Professional - Mt. Vernon, Washington
"It appears that we are headed in the direction of mandatory insurance coverage by employers and that Code 89 is directed toward that means."

Heating & Cooling Company - Cookeville, Tennessee
"The additional paperwork to assure compliance will increase my overhead costs thousands of dollars each year. Will this Section 89 benefit my employees? The answer is NO! The additional expense will cost my company business in the marketplace."

Insurance Agent - Vincennes, Indiana
"The 'actual' effects of this Section 89 law are totally opposite of those envisioned by the Congress and is eliminating health insurance coverage for millions of Americans who have enjoyed group health insurance provided by their employers in the past."

President, Construction Company - Sioux Falls, South Dakota
"I would rather have a 1% increase in income tax rate than risk complying with Section 89. Because Section 89 is really a tax increase in disguise."

President, Express Company - Fort Atkinson, Wisconsin
"As a result of a Section 89 seminar, I have decided not to pursue instituting a pension plan for our employees at this time. We are a small company employing 16 people. I just do not feel that we can afford the legal expense and potential risk from the uncertainties of this new legislation."

President, Electronics Company - Cornelius, Oregon
"Section 89 rules are so complex that even our small business of thirty people is looking at $800.00 in wasted expenses every year just to see if we comply. Mind you this money doesn't benefit either the employee or employer."

President & CEO, Construction Company - Jacksonville, NC
"Our company currently has in place, incentive programs for those key 20 employees on the form of pension and medical plans. The cost of these programs has been incorportated into our bid process through overhead factors. Enter Section 89. If we decide to maintain our existing program on a non-discriminatory basis our cost jumps from $15,000 per year to over $100,000 per year. Option #2 is maintain existing plans on a discriminatory basis and pay the price for consulting and compliance. This cost for employers our size is estimated to begin at $10,000 annually. Add to this, additional payroll tax on grossed-up wages, and our overhead factor increase becomes visible. Option #3, and our best option, is to scrap all programs, blame the decision on Section 89, gain a temporary edge on our competition, and keep our key people employed."

"Through implementation of so-called "socially equitable" programs such as section 89, our government has stepped in and begun eroding sound and fair business management philosophies and is slowly destroying the entrepreneurial spirit."

Insurance Agent - West Palm Beach, Florida

"Many of may accounts are contemplating dropping their group plans in favor of letting each employee buy his own individual policy."

"All the plans, and I mean all the plans, sold to 99% of all purchasers of group insurance contain the same level of benefits to all classes of employees. I have about 100 clients and all of my cases have the same benefit structure for all classes of employees. So what I am saying is that I and my employers know our plans do no discriminate in favor of highly compensated employees, because everyone has one level of benefit."

President, Advertising & Public Relations - Cheyenne, WY

"I have been considering offering my employees health insurance. Since trying to "figure out" what the so-called non-discrimination rules are, and the fact that the IRS has not issued regulations on how to comply, I have simply given up the idea."

Owner, Art Supply Company - New Albany, Indiana

"If Section 89 is not repealed, and/or if fringe benefits are taxed, we will be faced with only one just alternative to offering this program; to raise my employees wages up to include the additional we now pay in insurance benefits, and to let them shop for their own coverage."

President, International Business Transportation Services - Kansas City, Missouri

"Due to Section 89 our corporate attorney and accountant advises me that it will cost my firm approximately $3-4,000.00 per year to retain a company benefits consultant firm to test and submit compliance reports to the federal government? The existance of Section 89 will leave us with no alternative but to eliminate or greatly reduce our overall benefits, retirement plan, life and medical insurance benefits in order to simplify and afford to meet the administrative compliance nightmare for my firm."

0358T

[The following was subsequently received from the National Federation of Independent Business:]

SUBMISSION FOR THE HEARING RECORD ON H.R. 1864 TO SIMPLIFY SECTION 89 ANTI-DISCRIMINATION RULES

We, the undersigned groups who have been in the forefront of seeking repeal of Section 89 of the Internal Revenue Code, greatly appreciate the opportunity you have provided for substantial changes to Section 89 of the Internal Revenue Code. The introduction of H.R. 1864 makes a significant contribution to the debate on Section 89 and we look forward to continuing to work with you as the legislative process moves forward.

Employers who are members of the groups listed are concerned that Section 89 diverts attention and resources away from the goals of affordability and accessibility of health insurance.

The memberships of these organizations have reacted to the imposition of Section 89 out of frustration and anger over the enormous complexity and compliance burden which Section 89 imposes and the indiscriminant manner in which Section 89 affects both employer and employee health care costs.

While many of the key issues raised by the repeal committee with Section 89 have been addressed by H.R. 1864, other significant issues remain to be resolved. The easiest and best legislative solution to the enormous problems associated with Section 89 is its repeal.

We look forward to continuing to work with you and the other members of your committee.

Thank you for your consideration.

Sincerely,

Alliance of Independent Storeowners and Professionals
American Association of Nurserymen
American Consulting Engineers Council
American Council of Independent Laboratories
American Dental Association

American Machine Tool Distributors Association
American Road and Transportation Builders Association
American Society of Personnel Administration
American Subcontractors Association
Amway
Associated Builders and Contractors
Associated Specialty Contractors
Association of Physical Fitness Centers
Association of Physical Fitness Centers
Association of the Wall and Ceiling Industries-International
Electronic Industries Association
Electronics Representatives Association
Florists' Transworld Delivery Association
Independent Bankers Association of America
Independent Medical Distributors Association
International Association of Refrigerated Warehouses
Machinery Dealers Association
NMTBA-Association for Manufacturing Technology
National Association of Manufacturers
National Association for the Self-Employed
National Association of Brick Distributors
National Association of Personnel Consultants
National Association of Small Business Investment Companies
National Association of Truck Stop Operators
National Association of the Remodeling Industry
National Campground Owners Association
National Candy Wholesalers Association
National Coffee Service Association
National Council of Agricultural Employers
National Electrical Contractors Association
National Fastener Distributors Association
National Federation of Independent Business
National Food Brokers Association
National Grocers Association
National Lumber and Building Material Dealers Association
National Paperbox and Packaging Association
National Shoe Retailers Association
National Society of Public Accountants
National Soft Drink Association
National Tire Dealers and Retreaders Association
National Truck Equipment Association
North American Equipment Dealers Association
Opticians Association of America
Petroleum Marketers Association of America
Printing Industries of America
Professional Plant Growers Association
Retail Bakers of America
Small Business Legislative Council
Society of American Florists
Specialty Advertising Association International
Sugar Cane Growers Cooperative of Florida
U.S. Chamber of Commerce

Chairman ROSTENKOWSKI. Thank you, Mr. Gardner.

Mr. May.

STATEMENT OF ERNEST D. MAY, PRESIDENT, GEORGE J. HOWE CO., INC., GROVE CITY, PA, AND PRESIDENT, NATIONAL CANDY WHOLESALERS ASSOCIATION, INC.

Mr. MAY. Thank you, Mr. Chairman.

We appreciate the opportunity to testify. I will keep this verbal statement brief since you have heard a lot of this already today. But we do ask that the full written statement be submitted for the record.

Chairman ROSTENKOWSKI. Without objection, all the full written statements of the members of the panel will be included in the record.

Mr. MAY. Thank you.

My name is Ernest May, and I am president of the George J. Howe Co. in Grove City, PA. We are a small business wholesale distributor of nuts and candy products in northwestern Pennsylvania. We are a small business in that we have slightly less than a hundred employees.

I am here today on behalf of the National Candy Wholesalers of which I am serving a term as president. We want to recognize the chairman's leadership efforts to respond to some of the many concerns expressed by the business community. In particular, the legislation does take a major step toward attempting to reduce the burden of compliance. The bill eliminates a great deal of unnecessary recordkeeping and paperwork. The proposed legislation is a dramatic change from the present law, and a simplification effort is welcome news.

I might add that all of us in small business are under a burden of paperwork.

However, despite some major improvements, there are significant new impediments to promoting health care coverage by employers without imposing unjust restrictions. Congress should encourage the economic contributions of employers rather than attempting to mandate and regulate employee benefits. Therefore, we would support repeal or especially significant reform of section 89.

Thank you.

[The statement of Mr. May follows:]

STATEMENT OF ERNEST D. MAY
GEORGE J. HOWE, CO., INC. GROVE CITY, PA
AND PRESIDENT
NATIONAL CANDY WHOLESALERS ASSOCIATION

Mr. Chairman and Members of the Committee:

Thank you for providing us this opportunity to comment on H.R. 1864 and problems associated with non-discrimination rules of Section 89 of the Internal Revenue Code.

My name is Ernest D. May, and I am President of the George J. Howe Co., Inc. in Grove City, PA. We are a small business wholesale distributor of candy and nut products with distribution throughout northwestern Pennsylvania. We have about 100 employees. Accompanying me is Dennis Lavallee, the Associate Director and Director of Member and Government Relations of the National Candy Wholesalers Association (NCWA), and Gerald Panaro, our general counsel.

I am here today on behalf of the National Candy Wholesalers Association, Inc. for which I am currently serving a term as President. The NCWA is a national trade association with 900 wholesale distributor members and over 1700 manufacturer, broker, retailer and other associate members. Members are involved with the distribution of confectionery, tobacco, health and beauty aids and other allied products. This segment of the wholesale distribution industry has approximately 4400 establishments with a total annual sales volume in excess of $26 billion and over 69,000 employees. It is an industry composed of a great many small businesses who operate on narrow profit margins.

From when the association first became aware of the difficult burdens that Section 89 imposes on companies in the confectionery industry, we joined in support of efforts calling for its repeal. However, we want to recognize the Chairman's leadership efforts to design significant changes that attempt to respond to some of the many concerns expressed by the business community. H.R. 1864 is a good first step toward resolving some of those problems. However, we must reject government restrictions that tie the hands of employers who are trying to run profitable businesses, while serving the interests of their employees. Thus, despite your efforts, we are still constrained to support repeal.

Section 89 is Counter Productive.

As the Committee is aware, Section 89 was enacted as part of the Tax Reform Act of 1986. It outlines the employer's requirements for employee benefits programs to be eligible for a tax deduction. Furthermore, it prescribes nondiscrimination rules for employers to use to assess whether employer provided health, life, and accident insurance programs favor more highly compensated employers over less highly compensated employees. If discrimination occurs, the excess value must be reported to the employee and is subject to taxation on personal tax returns. If an employer fails to report the excess value, the benefits are taxable on the employer's tax return.

This over simplified explanation far understates the immense complexity required. There are additional detailed record keeping and complicated tests necessary to determine compliance. It's an onerous administrative burden imposed on large and small businesses alike. Many small businesses who cannot afford in-house employee benefits experts are faced with turning to expensive outside consultants to address the difficult job.
All in all, it will be expensive to comply, with no demonstrable benefit to employees.

In fact, Section 89 may prove to be counterproductive to the goal of reducing the ranks of the uninsured. Many employers may eliminate flexible options they have offered to meet the needs of employees. Some may drop benefits altogether and increase compensation for highly compensated employees. Employees would no longer be covered by more economical group rated plans and find themselves in an expensive market for individual policies. Some may choose not to insure at all, thus causing an increase in the ranks of the uninsured.

We commend Congress on your desire to insure that social policy objectives are achieved. Enactment of Section 89 uses the tax code to continue the tax benefits of employer-provided programs. Unfortunately, the complexity and administrative burdens imposed on businesses of all sizes as a result of these attempts to comply with Section 89 far exceed the benefits derived from the government's original objectives.

Section 89 should be unmasked for what it is! It's a back door attempt to mandate employee benefits and to tax benefit programs that don't fit into the law's rigidly defined mold. While it may prove to be an excellent revenue raising scheme, it will be counterproductive to lowering the number of uninsured.

NCWA also believes that faith in the legislative and regulatory process has been seriously undermined by the manner under which Section 89 has been imposed. The proposal was approved by Congress without any specific hearing on the impact of the legislation. Although Congress directed the IRS to issue regulations to provide guidance, none was forthcoming until this spring. It's been two years since enactment. Meanwhile, businesses were faced with compliance with the statute that took effect this past January 1. That tough enforcer of deadline for taxpayers missed its own deadline by months.

Flexibility is Key

While we continue to support repeal, we have closely examined the Chairman's starting point for consideration of reforms. As stated by the Chairman on April 13, 1989 when H.R. 1864 was introduced, "The tax-favored treatment of employer provided fringe benefits.... is justified only if the tax benefits further important social policy objectives." However, in addition, the law should not tie the employer's hands. It should permit employer flexibility in determining both the level of benefits offered to employees as well as the methods by which the benefits are determined.

Employers have been quite ingenious in identifying the needs of employees and in designing unique programs that address those needs in our efforts to attract and retain good employees. The various benefits that are covered by the current Section 89 qualification rules include the following:

a. Accident and/or health plans
b. Group term life insurance plans
c. Qualified tuition reduction programs
d. Cafeteria plans
e. Fringe benefit plans involving employee discounts
f. Welfare benefit trusts
g. Qualified group legal service plans
h. Educational systems programs
i. Dependent care assistance programs

Although the qualification rules for an employee benefit plan to be deductible apply to each of these, the new testing procedure contained in H.R. 1864 addresses only the health benefits and term life insurance benefits. The legislation calls for the inclusion in taxable income of an amount equal to the value of the employee's benefit if he is classified as a highly compensated employee.

In order for employers to survive in today's business environment, the employer must be allowed to determine which benefits should be offered to employees and how those benefits should be calculated. The employer should retain the flexibility to determine the extent of the coverage he wishes to provide employees while maintaining the sound financial footing necessary for a successful operation. It would be even more inequitable if employers were forced out of business because of mandatory programs instituted by the government. Accordingly, it is imperative that employers retain the flexibility to determine what, if any, benefits and programs should be offered to their employees.

Although H.R. 1864 attempts to rectify many problems in the existing law, it creates as many new ones that would need to be addressed.

Qualification Requirements Need Expansion.

H.R. 1864 calls for making core health plans available to 90% of all employees who are not highly compensated. This 90% eligibility rule is a significant improvement over the existing law which requires actual coverage. However, the percentage should be lowered to 70%.

An example may help to explain. Company A offers several core benefit packages ranging from the Cadillac to the Chevy. The employer pays 50% and the employee pays 50%. Some employees may select the Chevy option which would require an employee contribution of under the $10.00 per individual and $25./family standard in H.R. 1864. Other employees may opt for the Cadillac version (e.g. with lower deductibles for the same core coverage). As a result, the employee's cost would likely exceed the $10./$25. standard. Although the employer is also paying more in matching premium for these employees, the core benefits package would not qualify. Faced with the prospect of loosing the deductibility of the core health benefits package, company A would probably stop offering the better coverage desired by some employees.

Dropping the thresholds to 70% will encourage more employers who offer a range of care coverage to continue to do so. Thus, the provision urging employers to make core coverage available is an improvement. However, it should have a lower threshold.

Eligibility tests are too rigidly narrow.

The Chairman's bill (H.R. 1864) attempts to make a quantum leap in simplifying the eligibility test for Section 89 coverage. Unfortunately, the move toward simplicity has also been a move toward inflexibility at rigidly low levels.

With respect to the definition of a qualified core health plan, it places a cap on employee contributions of $10.00 per week or $25.00 per week in the case of family coverage. Despite the Chairman's stated intent that the employee dollar amounts be indexed for wage growth, it provides little assurance to Congress that coverage would continue with the current health care climate. Insurance premiums have been escalating at a rate several times faster than wage or consumer price index growth. Some existing care coverage plans will not be eligible under these starting levels. Even more would lose eligibility as costs escalate faster than wage rates.

In the Chairman's floor statement on introduction, he notes that "without such a limitation, an expensive plan could meet the eligibility requirements of the bill and yet fail to meaningfully expand the availability of coverage because of the unrealistic financial burden." If expansion of availability is indeed an objective of the legislation, the growth in premium cost is thrust on the employer even more extensively if he wants to assure deductibility. This could result in reduction of coverage or elimination altogether.

As long as there is no discrimination among employees, there should be no maximum dollar amounts placed on the employee contribution. The placing of specific dollar amounts does not further the overall purpose or objective of the simplification legislation. The purpose and objective should be to insure that the same benefits provided to highly compensated employees be available to non-highly compensated employee. The cost of insurance and competition between employers will continue to serve as the valuable check it has in the past against outrageous premium and benefit levels. Consequently, if the cost per worker is the same, regardless of the levels of compensation, there is no discrimination. The specific references to dollar amounts relative to employer-provided benefits and employee contributions should be deleted from the proposed legislation.

Part time employees should be excluded.

Although H.R. 1864 makes some improvement in the definition of the part time employees that can be excluded in making the eligibility determination, it also drops a positive provision that is in the existing Section 89. Under the existing law companies with less than 10 employees may exclude employees who normally work 35 hours or less per week. The 35-hour test should be retained. Since 40 hours of work is generally considered full-time, the inclusion of anyone in excess of 35 hours would, be more meaningful. The proposed legislation has increased the definition of a part time employee from 17 1/2 hours to 25 hours to be included in the plan. However, Congress should consider an even higher level.

Smaller employers generally pay higher insurance rates because of the smaller group on which to base a rating and because of higher insurance administration costs. With a lower threshold for part-time, small employers face continued high premium cost for a labor force that potentially turns over more and results in higher administrative costs. The higher part time threshold for smaller employers will produce greater equity between rates paid by smaller and larger employers.

Extend the waiting period.

Furthermore, the proposed legislation provides that employees with less than six months of service be excluded from consideration. New employees frequently must undergo educational training to prepare for the job. The educational requirements may last anywhere from one month to six months in duration. Consequently, an employee may not actually begin productive work prior to a six-month time period. Substantially more time than six months would enable the employee, as well as the employer, sufficient time to determine whether or not the employee will be an ongoing member of the team. A six month time period is too short and may cause additional record keeping for adding and subtracting employees from the plan. By excluding employees who work for less than twelve months, record keeping requirements are reduced and premium dollars can produce greater benefits for employees who remain with the employer. The six-month time period should be changed to a twelve-month time period. There is no discrimination for employees who remain with the employer for the longer time period.

Labor agreements should be excluded.

The Chairman's bill very wisely and appropriately indicates that union employees or any qualified bargaining unit shall be treated separately. However, the language of the proposed legislation indicates that the requirements would still have to be met even under union contracts. It would be much easier and simpler if union contracts, would simply be excluded from the law altogether. If a good faith bargaining has occurred, there should be no reason to have additional responsibilities for compliance on the employer. Furthermore, since the general purpose of both existing law and the proposed legislation is to prevent discrimination with higher compensated employees, union negotiation accomplishes that. A primary purpose of collective bargaining is the equalization of benefits between the employer and represented employees. Consequently, the government should not impose additional responsibilities for compliance. Good faith bargaining between employee representatives and employers should be excluded from testing compliance under Section 89 and the proposed legislation.

Leased employee thresholds needs change.

Congress should exempt bona fide leased employees. As long as leased employees do not constitute more than 50% of the recipient's non-highly compensated work force they should be excluded. Furthermore, imposing a certification requirement that such employee is eligible to participate in a qualification core health plans should be dropped. If leased employees constitute less than 50% of the recipient's non-highly compensated work force, the recipient has little control over the benefits that the leasing organization may have for the employees. Consequently, the employer should not be required to maintain insurance for leased employees if they constitute less than a majority of the work force. Congress should drop the requirement for certification of eligibility of leased employees to participate in qualified core health plans of the leasing organization when leased employees constitute less than 50% of the employer's work force.

The bill flunks cafeteria plans.

In an era of increased attention to addressing a diversity of employee needs, employers have increasingly turned to cafeteria plans or other flexible approaches. If a confectionery distributor offers a cafeteria plan, by definition there is a significant probability that the benefits program will not pass the eligibility tests. H.R. 1864 treats these alternatives particularly harshly.

For example, company B offers a core health plan, an educational assistance plan or an "in lieu of" cash payment. More than 10% of the employees have working spouses covered by family coverage medical plans and another 10% use the company's education assistance plan. If either group opts out of the core health plan in favor of other options in the cafeteria plan, company B will not pass the eligibility tests.

With the growing popularity of cafeteria plans which better meet employee needs, it would be a travesty to discourage them through Section 89 testing. Any legislative remedy to problems associated with Section 89 compliance should be designed to limit the adverse impact on cafeteria plans.

Penalties are not equitable.

For benefit plans to qualify for the tax deduction, under the existing Section 89, plans must pass a five (5) part qualification test (i.e.that the plan be in writing, that employees be notified of plan provisions, that the plan be maintained for the exclusive benefit of employees, that employee rights be legally enforceable, and that the plan is intended to be maintained for an indefinite period of time). We have no quarrel with the merits of the qualification tests. However, the 34% excise tax for failure is exorbitant. Since the bill is supposed to be fair and equitable regardless of the number of employees or size of the company, there should not be an undue burden placed on less profitable companies with the flat tax rate stated in the bill. Smaller or less profitable companies that fail to meet the plan should not be penalized unfairly. Consequently, if the marginal rate for less profitable companies equals the excise tax rate, the less profitable employers will not be penalized inequitably compared to more profitable employers. Under the proposed legislation, the most profitable employers are already at the 34% rate and obtain a tax deduction at the 34% rate. However, a less profitable employer is not at the 34% rate and would be penalized to a much greater degree by having the rate specified in the bill. The excise tax should be changed to the marginal tax rate that the employer is required to pay in the year in which the plan does not meet the qualification requirements.

Is "highly compensated employee" properly defined?

The definition of the term "highly compensated employee" has been given the meaning as defined under Section 414 (q); however, the Chairman's floor statement indicates that all employees who receive in excess of $45,000 compensation will be classified as highly compensated. A reading, however, of the proposed legislation does not contain any indication of the $45,000 level. A clarification of this provision needs to be made.

Compliance burden is reduced.

Despite several very critical drawbacks in H.R. 1864, the legislation does take a major step toward attempting to reduce the burden of compliance. The bill eliminates a great deal of unnecessary record keeping and paperwork. Furthermore, it dramatically reduces the need that many wholesale distributors and other confectionery related businesses were feeling to rely on benefits consultants, attorneys and accountants to assist with compliance. NCWA compliments the Chairman for your leadership in attempting to carefully craft those changes.

CONCLUSION

In conclusion, we compliment the Chairman for this excellent first step toward improving compliance with Section 89. However, despite some major improvements, there are significant new impediments to promoting health care coverage by employers without imposing unjust restrictions. Thus, the most simple and direct approach is repeal of Section 89 as proposed by Rep. John Lafalce and approximately 300 of your colleagues in H.R. 634.

However, if the committee plans to pursue the law, the committee needs to make the following changes.

o any legislation aimed at simplification should simultaneously have at its core, the flexibility for an employer to determine, what benefits and programs should be offered and in what manner.

o Although the eligibility requirement has been changed to a test of availability to employees, the threshold should be lowered to 70%.

o Specific reference to the $10. individual coverage and $25. for family coverage for employee participation should be dropped.

o Although raising the definition for part time employees to 25 hours is an improvement, the threshold should be 35 hours.

o Benefit plans resulting from good faith bargaining with collective bargaining representatives should be excluded from the legislation.

- Certification for leased employees should not be required of employers with than 50% leased employees.

- Penalties for non compliance with qualification rules should be more equitable.

- The adverse impact of compliance on cafeteria plans should be reduced.

The proposed legislation is a dramatic change from present law and the simplification effort is welcome news. However, Congress should encourage the economic contributions of employers rather than attempting back door methods to mandate and regulate employee benefits. Thus, we continue to support repeal of Section 89.

I want to thank you for this opportunity to present our views. We would be happy to attempt to answer any questions.

Chairman **Rostenkowski**. Thank you, Mr. May.

Mr. Gardner, you addressed the problem that I recognize—as a matter of fact, this weekend, the Committee on Ways and Means was on a working retreat—the problem of health care and addressing it. There is no question in my mind that Government, labor, and corporate America are going to have to get together and take some leadership with respect to the costs that we are incurring. We pay more for health care in this country than any other country in the world. And according to some of the discussions that we had over this weekend, we are not getting as much for our dollar as other countries are with respect to providing health care.

What do you think? Do you think that there is the possibility that the three of us, the three entities that are so important, can get together and do something about this?

Mr. **Gardner**. I think the possibility of not being able to do it is much more frightening to me. It is something that we have to address, and with all the constituents you describe.

Chairman **Rostenkowski**. Well, I think the cost in the health area is increasing by 12 percent annually, and in dollars I think we are talking about $53 billion in the last 8 to 10 years.

It is something, really, that we are going to have to address, and the only way I believe it is going to get done is by those three entities getting together and doing something about it.

Mr. McGrath.

Mr. **McGrath**. Thank you, Mr. Chairman.

Mr. Alexander, one area that Mr. Fay also testified on today and that is not addressed in the bill concerns multiemployer plans. The problem is that the manner in which we treat unions in public employment does not seem to be adequate for private sector multiemployer plans.

I am wondering whether or not you have been able to come up with any solutions to this problem other than exemption.

Mr. **Alexander**. Mr. McGrath, in our statement, we recommend generally—now talking about section 89 and not about the penalty part of it that I discussed briefly with you and Mr. Pickle a few minutes ago—that multiemployer plans should not be included unless the employer has to meet that 90 percent cliff test by including the multiemployer plan and such employer is in a position to accept the supervisory responsibilities that are provided in the bill. Now, that will be a very rare and unusual situation. If that situation occurs, if substantially all the nonhighly compensated employees of a particular employer are in multiemployer plans, and if at least with respect to one of those plans the employer can exercise the rights necessary to assume the responsibilities of the plan, then we suggest in our statement that it would be appropriate to include the plan, but only for that purpose.

Is there a real problem with multiemployer plans? The problem that we are worried about is discrimination. Is that present in the multiemployer context? We went through this in ERISA, and we found that multiemployer plans were quite different from other plans. We found that the problem that we were addressing did not reside in multiemployer plans, or if it did, only to a minor extent and with different attributes.

Now, the bill does take over from TAMRA, from last year's correction, a very worthwhile provision with respect to multiemployer plans that makes it possible for an employer to contribute with, subject to certain exceptions which are somewhat troublesome, a lesser risk than that which section 89 originally envisioned.

Mr. **McGrath**. Can you give me your views on the following hypothetical situation? An employee, covered by a union's collective-bargaining agreement works on the docks of New York in the morning for 3 hours for an export-import company and unloads the ship. From 12 to 2, he works for somebody else, and from 2 to 4, he works for somebody else.

The fix that we have for public employees is that only the unit, the collectively bargained unit, would be tested. That does not seem to work in the private sector.

Is the problem that when you are tested as a company that there are some employers who may not fit the highly compensated aspect of it? Where is the problem private sector collectively bargained units?

Mr. **Alexander**. Well, there are two problems.

Mr. **McGrath**. Well, let me ask Mr. Fay.

Mr. **Alexander**. I just want to add one thing and then turn it over to AGC. There are two problems, one of which is the problem that is in the new section 89 in the chairman's bill, which we all think is a great step forward, in general. The other problem deals with the standards for qualification and who gets stuck if those standards are not met.

Mr. **McGrath**. Just the penalty, then.

Mr. **Alexander**. Right. And I did not want to lose sight of that second problem.

Mr. **McGrath**. OK. Mr. Fay.

Mr. **Fay**. The problem comes that we, the contractor, whether we negotiate the contracts as an individual contractor or through an association, we sign to pay a certain dollar or cents per hour. That amount is sent into a fund for which we have absolutely no control of. The benefits from it, the administration, they are all done by the administrator. In fact, it is a great example of labor and management working together because they are jointly trusteed funds. But they might have a hundred contractors that represent 30,000 employees in those funds.

So, you know, as far as the penalty standpoint, it is very difficult to try to penalize us as an individual contractor for something that we have no control of. Just at the present time in my little company, we are paying into 35 different union health plans on the east coast. I have never even seen the plans, much less know how they work. All we are is responsible for a cents per hour.

Mr. **McGrath**. Well, how is it that the fix that we have in for the collectively bargained unit in public employ would not work here, if it exempts you as a——

Mr. **Fay**. Well, it should totally exempt the contractor from the penalty situation, and the burden of proof should be on the plan administrators. And that is not the way it is. That is the way it should be.

Mr. **Alexander**. Mr. McGrath, the reason for the shift to the excise tax approach problem, the penalty on the employees if the qualification standards were not met, was stated because the employees had no control over the plan. Here the employer has no control over the plan, and the employer in the multiemployer context, like the employees, should not be penalized for an action taken by someone over whom the employer has no control.

Mr. McGRATH. This is something we will have to wrestle with. Thank you.

Chairman ROSTENKOWSKI. Are there any further questions? If not, gentlemen, thank you very much for joining us this afternoon.

Mr. GARDNER. Mr. Chairman, Mr. McGrath had asked a question of the previous witness, and I wondered if I might just respond, because the previous witness was unable to. The question dealt with the adequacy of the $10 and the $25. I would like to just share the experience of our own corporation.

We provide and pay for 100 percent of the employee portion of premium and 50 percent of the additional charge for dependents. And I would hope that there would be some agreement that we are on the right track of doing the right thing for our employees.

Our premiums are $160 a month for single employees and $460 a month for families, and we fail your test.

Mr. McGRATH. That was one on the other side of the coin. That was one of the problems with the $10 and $25 premiums. We did not want to have employers out there reducing their benefits to their employees because of these amounts.

Mr. GARDNER. I understand. What I had understood you to say earlier was that you thought that $10 a week was probably going to be in the ball park; maybe the $25 was a little short. And I wanted to share with you a real life premium so you could see the kind of numbers that we have to deal with, at least in California.

Mr. McGRATH. I think some of the numbers that we have received indicated that, in the aggregate, they fit. But there are obviously some exceptions.

Mr. GARDNER. Thank you.

Chairman ROSTENKOWSKI. Thank you very much.

Mr. Calhoun, Mr. Thomas, Mr. Wood, Mayor Cooke. Welcome to the committee, gentlemen. It is a pleasure to have you join us. We are looking forward to your testimony.

At this time, I would like to yield to my colleague from Texas, Mr. Pickle.

Mr. PICKLE. Mr. Chairman, I thank you. I want to officially present one of the panelists here in this next panel. He is the mayor of my city and my personal friend. He comes from the business world. He served as president of the Austin Chamber of Commerce, and now he is the mayor of the best city in the United States. All of us appreciate the service that he is giving. He is an outstanding mayor, and I am delighted to have him here as one of the witnesses.

I welcome you to Washington, Mayor Cooke.

Mr. COOKE. Thank you very much, Congressman.

Chairman ROSTENKOWSKI. Mr. Mayor, you can begin the testimony.

STATEMENT OF HON. LEE COOKE, MAYOR, AUSTIN, TX, AND VICE CHAIR, FINANCE, ADMINISTRATION AND INTERGOVERNMENTAL RELATIONS POLICY COMMITTEE, NATIONAL LEAGUE OF CITIES, ALSO ON BEHALF OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION

Mr. COOKE. Thank you very much, and it is a pleasure to be here today, and certainly to be here with my Congressman, one of the best Congressmen in the country.

Chairman ROSTENKOWSKI. I think you would get an argument there. [Laughter.]

Mr. COOKE. I would like to say, Mr. Chairman, I am Lee Cooke, the mayor of the capital city of the State of Texas, mayor of Austin, TX, and I am here to testify on the issue that is having a very costly impact on cities and counties, as well as States. I would like to acknowledge Representatives Archer's and Kennelly's comments today about their concern about local governments, and I appreciate their concern.

On behalf of the National League of Cities and the Government Finance Officers Association, we do appreciate your leadership and swift response to the concerns caused by the implementation of section 89. I recognize the legitimate congressional concern that taxpayer dollars must be spent in a fair and equitable way. The expenditure of $40 billion a year to encourage employers to provide adequate health care benefits is a major Federal commitment, and I acknowledge that.

Public examination on how this money is spent is understandable. Our concern is that local and State benefit packages have already been very closely scrutinized through our own legislative process, and the Federal review is an additional costly administrative burden, and we believe the burden outweighs the benefits.

Most State and local governments offer the same benefit packages to all employees, and participation is really very high. Take in the city of Austin, TX. We have 8,953 permanent employees, and 94 percent of those employees are covered under the city-sponsored plan. It is estimated by the Society of Professional Benefit Administrators that the compliance costs could be as much as $50 per employee, especially in the smaller cities. Nationally, this could mean as much as $700 million annually to test the benefits of our 14 million State and local government employees.

This mandate could not come at a worse time for us. Cities are trying to deal with certainly the drug problem, affordable housing prices, and a crumbling infrastructure in the wake of Federal disinvestment in the State and local governments. Compliance would be an unnecessary fiscal constraint on our already dwindling fiscal assets.

We do applaud you and the introduction of House bill 1864 to provide substantial relief to State and local governments. Almost half of the 87,000 State and local governmental entities will benefit from the modifications in the definition of highly compensated to exclude the requirement that the highest paid officer must be considered the highly compensated, regardless of salary level.

We would encourage you, as the chairman, and the Treasury Secretary to clarify in a public statement that entities that meet this revised definition would be exempt from section 89. Our concern is that many of the small governments will expend funds over the next few months before October 1, before this legislation is actually passed. Many consultants are already knocking at the doors of a lot of the small government entities throughout the country, asking to come in and do the testing, and we are fearful that they will spend a great deal of money unnecessarily between now and then.

Other beneficial aspects of H.R. 1864 include change in the definition of part-time employees from 17.5 hours to 25. We would ask for a clarification under the bill's definition of employee to exempt prisoners from testing, though. Also, consideration of dropping the testing of employer-provided life insurance and relying on existing rules would actually simplify compliance. For the city of Austin, this could save us $350,000 after October 1.

We are also concerned over the employee contribution levels in the bill. At least 27 States would exceed either or both the $10 single or $25 family contribution rate. States and localities will be more affected by this rule because our employees contribute more often and at a higher rate than many in the private sector, which is where I spent most of my career. We suggest that dollar limits be dropped and that the compliance turn on the availability of the plan through State and local governments. If dollar amounts remain the same, existing contributions should be grandfathered, and indexing of these amounts should be tied to the medical cost index.

There are many other points that I would make. Let me just go on to say that the different treatment of salary reduction of highly and nonhighly compensated employees will severely curtail the operations or creation of cafeteria plans. Salary reductions are treated differently for highly compensated or nonhighly compensated employees, which create a problem in testing. When contributions are employer-provided for highly compensated employees, it immediately throws off the testing. It provides a natural bias which makes a cafeteria plan seem discriminatory. This treatment will violate the benefits testing clause, the benefits to become taxable to the highly compensated.

Salary reduction arrangements, including medical expense reimbursements, offer significant tax arrangements, including medical expenses, and this is not a discriminatory income issue, but how to provide employees with insurance to protect them regardless of whether or not the cafeteria plan exists.

Mr. Chairman, many State and local governments offer retiree health care insurance. Some are entirely retiree-paid; others are paid by we, the employers, and some are a combination. Almost half of the States make no contribution, while 16 States pay full cost for single coverage. One important reason for offering these benefits is to allow retirees to purchase health care at group rates.

Under the bill, if the retirees pay the amount that exceeds the eligibility test amount, the benefits will become taxable to the highly compensated retiree, which will discourage the purchase of health care coverage. This could lead to elimination of the benefit of future retirees and an increased strain on the Medicare system.

The private sector, Mr. Chairman, has many more options for complying with section 89. They can drop benefits entirely, switch to employee-paid benefit plans, or grossing up the salaries of the highly paid to compensate for any additional tax or excessive benefit. Public employers, local governments, cities have fewer options. Benefits are viewed as a contractual right of employment and are set by legislative means, making diminishment or elimination nearly impossible. Also, the public sector budget constraints make the grossing up option fiscally out of reach.

The differences strongly suggest that selective treatment under section 89 should be provided for States and local government. We understand the intent of the law, and that is not to federally subsidize discriminatory benefits, and I am committed to see that not happen. But we would like to suggest and remind the committee that State and local government employee benefits costs are not a deductible expense for public employees, but rather the employers contribution and they are a direct cost.

I appreciate the opportunity to provide these comments. I know a number of them have been made throughout the day and they will be made by other members of this group. But it is very important that we get this on the record for both the National League of Cities, and I appreciate the opportunity to be here.

[The statement of Mr. Cooke follows:]

Statement of Hon. Lee Cooke, Mayor, City of Austin, Texas, on Behalf of the National League of Cities and the Government Finance Officers Association

Mr. Chairman, my name is Lee Cooke, and I am the Mayor of the City of Austin, Texas. It is with interest and concern that I testify before the Committee today on an issue that is having a direct and costly impact upon the nation's cities, counties and states. We appreciate your leadership and swift response to the concerns expressed by all sectors over the disruption caused by the implementation of Section 89. I am here today on behalf of the 16,000 member cities of the National League of Cities and the 11,000 state and local finance officials of the Government Finance Officers Association.

Let me begin by first recognizing the legitimate Congressional concern that taxpayers' dollars must be spent in a fair and equitable way to reach desired social needs. We at the state and local level of government apply this rule every day in the running of the nation's municipalities. The expenditure of approximately $40 billion a year to encourage employers to provide adequate health care benefits to workers is a major federal commitment and requiring public examination on how those dollars are spent is understandable. The question for state and local governments is that their benefits packages have been publicly scrutinized through their own legislative processes and the taxpayers of their jurisdictions. The federal review is an additional costly administrative burden.

We believe that the burdens of the law far outweigh the benefits in the public sector. Typically, state and local governments offer the same benefit package to all employees. In a recent Bureau of Labor Statistics publication, "Employee Benefits in State and Local Government 1987", it is reported that 94 percent of full-time state and local government workers participate in an employer-sponsored health care plan. So not only are benefits equitable between highly and non-highly compensated workers but participation in the plans is extremely high. For example, in Austin we have 8953 permanent employees and 94 percent are covered under a City sponsored plan.

It has been estimated by the Society of Professional Benefit Administrators that the compliance cost will be at least $50.00 per employee. On a national basis this would mean $700 million annually to test the benefits of our collective 14 million state and local government employees. This federal mandate could not have come at a worse time as the nation's cities, counties and states are trying to deal with drug abuse, an affordable housing crisis, and a crumbling infrastructure all in the wake of federal disinvestment in state and local government. Having to spend the few resources we have on an administrative exercise only to prove we are not discriminating in the provision of employee benefits is an unnecessary fiscal strain.

Benefits provided by state and local government employers undergo a process of public review, be it by the state legislature, the local council or at the bargaining table. Because this scrutiny allows little room for discrimination an exemption should be extended to the public sector.

Simplification Efforts

Efforts to simplify the existing law provide considerable relief to state and local governments and we applaud the introduction of HR 1864. Small governments in particular will be helped by the change in the definition of highly compensated as it relates to officers. Approximately half of the 87,000 state and local governmental units will benefit from the modification in the definition of highly compensated to exclude the requirement that the "highest paid " officer must be considered highly compensated regardless of salary level. We would encourage the Chairman and the Secretary of the Treasury to clarify in a public statement that entities that meet this revised definition will not have to undertake Section 89 testing. Our concern is that many small governments will expend funds over the next few month, before the legislation is passed, to comply with the law unnecessarily.

Other beneficial aspects of HR 1864 are changing the definition of a part-time employee from 17 1/2 hours to 25 hours. We would ask for a clarification under the bill's definition of employee to exempt prisoners from testing. Also, dropping the testing of employer-provided life insurance under Section 89 and relying on existing rules will simplify compliance.

Areas of special concern for state and local government are:

o Contribution Limits

We are concerned, however, over the employee contributions levels that are set out by the bill. In reviewing the level of employee contributions in state plans we have found that at least 27 states would exceed either or both the $10 single/$25 family contribution rate according to the "1988 Survey of State Employee Health Benefits Plans" by Martin E. Segal Company (See Appendix A). The states are Arizona, Arkansas, California, Colorado, Florida, Idaho, Illinois, Kansas, Kentucky, Louisiana, Minnesota, Missouri, Montana, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah Virginia, Wisconsin, and Wyoming. States and localities will be more affected by this rule because our employees contribute more often and at higher rates than their private sector counterparts. Therefore, we suggest that for state and local governments the dollars limits be dropped and compliance should turn on the availability of the plan. If the dollar amounts are to remain, at a minimum existing contributions should be grandfathered and the indexing of these amounts should be tied to a medical cost index.

o Collectively Bargained Plans

State and local governments should have the option of testing collectively bargained plans as separate units or in aggregation with other plans. Moreover, benefits of union employees are set through the collective bargaining process. Neither the employer or the employee has total control over the outcome but both have an opportunity to influence the outcome. Because of this mutual input into establishing benefits collectively bargained benefits should be exempted from Section 89 testing.

o Definition of Employer

In the state and local government sector the definition of employer may not be as clear as in the private sector. Often operational responsibility and plan responsibility is not held by the same entity. For testing purposes the employer should be the entity which has budgetary authority over the administration of the benefits. For example, school district employees should be tested separately from the general workers of the city. Where there is a state-wide administered plan the central administrator of the plan should be responsible for testing.

o Excise Tax on State and Local Governments

While the imposition of penalties for delibrate violations by employers are appropriate we are concerned with any proposal to impose a federal excise tax on another level of government.

o Cafeteria Plans

The different treatment of salary reductions of highly and non-highly compensated employees will severely curtail the operation or creation of cafeteria plans. Salary reductions for highly compensated are treated as employer contributions and as employee contributions for non-highly compensated creating a bias that in most cases will cause these plans to fail the benefits test and become taxable to the highly compensated. Salary reduction arrangements, including medical expense reimbursements offer significant tax advantages to all employees and result in health coverage being more available, flexible and affordable to all employees. This is not an issue of discretionary income but rather how to provide employees with insurance to protect themselves from health risks and expenses they face regardless of whether or not a cafeteria plan exists. We ask that this area be reviewed and a rule be developed that will allow these type of plans to continue.

o Retiree Plans

Many state and local governments offer retirees health care insurance. There are many different permutations as to how the benefits are paid for. Some are entirely retiree paid, others entirely paid for by the former employer or a combination of retiree-employer paid. Almost half the states currently make no contribution while 16 states pay full cost for single coverage. One important reason for offering these benefits is to allow retirees to purchase health care at group rates. This cost savings measure, whether or not the former employer pays a portion of the premium, is used to encourage retirees to purchase health coverage. Under the bill if the retiree pays an amount that exceeds the eligibility test amounts the benefits will be come taxable to the highly compensated retiree thereby discouraging the purchase of health care coverage. An undesired affect could be elimination of the benefit to future retirees and increased strain on the Medicare system. We encourage that retiree health care plans be given special considerations to avoid any unintended adverse behavior.

Fewer Compliance Options for Public Employers

The private sector has many more options available to it for complying with Section 89. For instance, they can drop benefits entirely, switch to employee paid benefits or gross-up the salaries of the highly paid to compensate them for any additional tax that must be paid on excess benefits. Public employers have fewer options. Benefits are generally viewed as a contractual right of employment in the public sector and are set by legislative means making diminishment or elimination nearly impossible. Moveover, budget constraints make the "grossing-up" option fiscally out of reach. Thus, in an ironic twist, in the private sector where the majority of discrimination occurs, employers are in a better position to continue to favor highly compensated employees.

Treatment of State and Local Governments Under Section 89

The differences discussed above strongly suggest that selective treatment under Section 80 should be provided for state and local governments. Although we clearly understand the intent of the law--not to federally subsidize discriminatory benefits--we must remind the Committee that state and local government employee benefit costs are not deductible expenses for public employers but rather that the employers' contributions are a direct cost. Therefore, we provide benefits to our employees without federal incentives and for good public policy reasons.

I appreciate the opportunity to testify before the Committee today. Mr. Chairman, I am available to answer any questions.

Questions concerning this testimony should be directed to Leslie Wollack, National League of Cities (202) 626-3020 or Cathie Eitelberg, Government Finance Officers Association (202) 429-7250.

Appendix A

TABLE 2

MONTHLY CONTRIBUTIONS TO STATE EMPLOYEE HEALTH BENEFIT PLANS JANUARY 1987 AND JANUARY 1988

EMPLOYEE ONLY COVERAGE

STATE	COST TO EMPLOYEE 1987	COST TO EMPLOYEE 1988	COST TO STATE 1987	COST TO STATE 1988	TOTAL COST 1987	TOTAL COST 1988	PERCENT OF TOTAL COST PAID BY STATE 1987	PERCENT OF TOTAL COST PAID BY STATE 1988
ALABAMA	0	0	125.00	142.00	125.00	142.00	100.0%	100.0%
ALASKA [a].......	0	0	222.60	309.76	222.60	309.76	100.0	100.0
	0	0	237.75	347.81	237.75	347.81	100.0	100.0
ARIZONA	1.00	1.00	86.78	92.48	87.78	93.48	98.9	98.9
ARKANSAS	9.26	9.26	70.00	80.00	79.26	89.26	88.3	89.6
	28.20	34.88	70.00	80.00	98.20	114.88	71.3	69.6
CALIFORNIA	0	0	77.22	78.39	77.22	78.39	100.0	100.0
	54.78	58.03	88.00	92.00	142.78	150.03	61.6	61.3
COLORADO	10.00	24.00	55.12	55.12	65.12	79.12	84.6	69.7
CONNECTICUT	0	0	100.80	100.80	100.80	100.80	100.0	100.0
DELAWARE	0	0	77.08	92.42	77.08	92.42	100.0	100.0
	20.30	24.34	77.08	92.42	97.38	116.76	79.2	79.2
FLORIDA [b]......	15.18	15.18	65.20	65.20	80.38	92.30	81.1	70.6
GEORGIA	13.60	14.70	68.55	81.98	82.15	96.68	83.4	84.8
	23.40	24.50	68.55	81.98	91.95	106.48	74.6	77.0
HAWAII	18.22	20.76	27.34	31.16	45.56	51.92	60.0	60.0
IDAHO	0	0	69.52	69.52	69.52	69.52	100.0	100.0
ILLINOIS	0	0	73.32	78.72	73.32	78.72	100.0	100.0
INDIANA	1.58	1.58	72.45	72.45	74.03	74.03	97.9	97.9
IOWA	0	0	75.06	84.00	75.06	84.00	100.0	100.0
KANSAS	0	1.00	92.55	111.47	92.55	112.47	100.0	99.1
KENTUCKY	0	0	69.79	79.71	69.79	79.71	100.0	100.0
LOUISIANA	39.52	48.20	39.52	48.20	79.04	96.40	50.0	50.0
MAINE	0	0	72.92	80.80	72.92	80.80	100.0	100.0
MARYLAND	11.51	20.22	65.25	78.52	76.76	98.74	85.0	79.5
	22.37	27.55	65.25	78.52	87.62	106.07	74.5	74.0
MASSACHUSETTS ...	11.65	14.66	104.84	131.93	116.49	146.59	90.0	90.0
MICHIGAN	11.12	5.58	100.14	105.68	111.26	111.26	90.0	95.0
MINNESOTA	0	0	69.70	77.72	69.70	77.72	100.0	100.0
MISSISSIPPI	0	0	72.00	72.00	72.00	72.00	100.0	100.0

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[a] State pays composite rate rather than separate rates for single and family coverage.

[b] Total cost for January 1988 is higher than sum of employee and State rates; difference is currently being paid out of group insurance fund surplus.

TABLE 2 (Cont'd.)

EMPLOYEE ONLY COVERAGE (CONT'D.)

STATE	COST TO EMPLOYEE 1987	COST TO EMPLOYEE 1988	COST TO STATE 1987	COST TO STATE 1988	TOTAL COST 1987	TOTAL COST 1988	PERCENT OF TOTAL COST PAID BY STATE 1987	PERCENT OF TOTAL COST PAID BY STATE 1988
MISSOURI	0	0	69.00	89.00	69.00	89.00	100.0%	100.0%
MONTANA	0	0	97.60	97.60	97.60	97.60	100.0	100.0
NEBRASKA	0	0	41.25	43.85	41.25	43.85	100.0	100.0
	11.26	12.47	44.47	46.64	55.73	59.11	79.8	78.9
NEVADA	0	0	129.20	136.00	129.20	136.00	100.0	100.0
NEW HAMPSHIRE ...	0	0	78.01	82.05	78.01	82.05	100.0	100.0
NEW JERSEY	0	0	65.89	73.46	65.89	73.46	100.0	100.0
NEW MEXICO	16.55	19.01	49.63	57.01	66.18	76.02	75.0	75.0
	26.48	30.41	39.70	45.61	66.18	76.02	60.0	60.0
NEW YORK	8.64	12.11	77.86	121.54	86.50	133.65	90.0	90.9
	10.06	14.38	91.99	141.93	100.63	156.31	91.4	90.8
NORTH CAROLINA...	0	0	63.82	93.82	63.82	93.82	100.0	100.0
NORTH DAKOTA	0	0	60.00	68.00	60.00	68.00	100.0	100.0
OHIO	25.50	28.35	68.95	80.70	94.45	109.05	73.0	74.0
OKLAHOMA	0	0	92.00	92.00	92.00	92.00	100.0	100.0
OREGON	0	0	90.68	97.14	90.68	97.14	100.0	100.0
- BLBB PLAN [c].	0	0	153.59	168.43	153.59	168.43	100.0	100.0
PENNSYLVANIA	0	0	56.15	64.05	56.15	64.05	100.0	100.0
	0	0	70.03	72.68	70.03	72.68	100.0	100.0
RHODE ISLAND	0	0	96.71	107.76	96.71	107.76	100.0	100.0
SOUTH CAROLINA...	0	0	67.27	78.03	67.27	78.03	100.0	100.0
	7.58	8.80	67.27	78.03	74.85	86.83	89.9	89.9
SOUTH DAKOTA	0	0	53.42	59.10	53.42	59.10	100.0	100.0
TENNESSEE	11.70	15.21	46.82	60.87	58.52	76.08	80.0	80.0
TEXAS	0	0	66.29	84.89	66.29	84.89	100.0	100.0
UTAH	8.25	8.49	74.25	76.42	82.50	84.91	90.0	90.0
VERMONT	10.85	12.29	43.40	49.14	54.25	61.43	80.0	80.0
VIRGINIA	0	0	78.36	82.28	78.36	82.28	100.0	100.0
WASHINGTON	0	0	64.52	66.46	64.52	66.46	100.0	100.0
WEST VIRGINIA ...	0	0	79.95	80.62	79.95	80.62	100.0	100.0
WISCONSIN [d]....	16.29	24.81	77.02	87.38	93.31	112.19	82.5	77.9
WYOMING	0	0	100.00	100.00	100.00	100.00	100.0	100.0

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[c] Rates shown are composite rates.

[d] Contributions vary by benefit plan and by county. State pays lesser of 90% of standard plan rate or 105% of lowest cost HMO in employee's county. Rates shown in table are for standard plan in Dane County (Madison).

TABLE 3

MONTHLY CONTRIBUTIONS TO STATE EMPLOYEE HEALTH BENEFIT PLANS
JANUARY 1987 AND JANUARY 1988

EMPLOYEE AND FAMILY COVERAGE

STATE	COST TO EMPLOYEE		COST TO STATE		TOTAL COST		PERCENT OF TOTAL COST PAID BY STATE	
	1987	1988	1987	1988	1987	1988	1987	1988
ALABAMA	90.00	102.25	125.00	142.00	215.00	244.25	58.1%	58.1%
ALASKA	0 0	0 0	222.60 237.75	309.76 347.81	222.60 237.75	309.76 347.81	100.0 100.0	100.0 100.0
ARIZONA	65.30	69.24	164.64	175.64	229.94	244.88	71.6	71.7
ARKANSAS	33.20 89.20	33.20 107.22	70.00 70.00	80.00 80.00	103.20 159.20	113.20 187.22	67.8 44.0	70.7 42.7
CALIFORNIA	0 139.29	0 142.49	198.26 219.00	217.59 233.00	198.26 358.29	217.59 375.49	100.0 61.1	100.0 62.1
COLORADO	119.00	144.88	55.12	55.12	174.12	200.00	31.7	27.6
CONNECTICUT	50.46	50.46	217.96	218.54	268.42	269.00	81.2	81.2
DELAWARE	0 48.78	0 58.50	189.60 189.60	227.32 227.32	189.60 238.38	227.32 285.82	100.0 79.5	100.0 79.5
FLORIDA [a]	55.64	55.6	122.80	122.80	178.44	205.48	68.8	59.8
GEORGIA	39.80 59.46	43.00 62.66	122.05 122.05	136.08 136.08	161.85 181.51	179.08 198.74	75.4 67.2	76.0 68.5
HAWAII	56.03	63.88	84.05	95.80	140.08	159.68	60.0	60.0
IDAHO	63.40	63.40	69.52	69.52	132.92	132.92	52.3	52.3
ILLINOIS	67.18 123.02	65.08 123.02	82.98 86.62	85.72 94.06	150.16 209.64	150.80 217.08	55.3 41.3	56.8 43.3
INDIANA	36.66	36.66	178.01	178.01	214.67	214.67	82.9	82.9
IOWA	59.12	59.12	113.54	135.36	172.66	194.48	65.8	69.6
KANSAS	158.12	174.06	92.55	111.47	250.67	285.53	36.9	39.0
KENTUCKY	97.00	111.10	69.79	79.71	166.79	190.81	41.8	41.8
LOUISIANA	90.96	110.96	90.96	110.96	181.92	221.92	50.0	50.0
MAINE	52.82	58.24	130.30	143.96	183.12	202.20	71.2	71.2
MARYLAND	33.83 61.27	50.40 68.72	191.73 191.73	196.44 196.44	225.56 253.00	246.84 265.16	85.0 75.8	79.6 74.1
MASSACHUSETTS	25.61	32.31	230.47	290.78	256.08	323.09	90.0	90.0
MICHIGAN	31.16	15.58	280.52	296.10	311.68	311.68	90.0	95.0
MINNESOTA	8.92	9.96	150.08	167.34	159.00	177.30	94.4	94.4
MISSISSIPPI	89.70	89.70	72.00	72.00	161.70	161.70	44.5	44.5

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[a] Total cost for January 1988 is higher than sum of employee and State rates; difference is currently being paid out of group insurance fund surplus.

TABLE 3 (Cont'd.)

EMPLOYEE AND FAMILY COVERAGE (CONT'D.)

STATE	COST TO EMPLOYEE		COST TO STATE		TOTAL COST		PERCENT OF TOTAL COST PAID BY STATE	
	1987	1988	1987	1988	1987	1988	1987	1988
MISSOURI	151.75	167.25	69.00	89.00	220.75	256.25	31.3%	34.7%
MONTANA	57.60	57.60	115.00	115.00	172.60	172.60	66.6	66.6
NEBRASKA	0	0	147.68	155.12	147.68	155.12	100.0	100.0
	39.95	44.26	159.23	165.51	199.18	209.77	79.9	78.9
NEVADA	83.90	100.90	129.20	136.00	213.10	236.90	60.6	57.4
NEW HAMPSHIRE ...	0	0	210.62	221.53	210.62	221.53	100.0	100.0
NEW JERSEY	0	0	160.56	178.45	160.56	178.45	100.0	100.0
NEW MEXICO	42.40	48.64	127.19	145.91	169.59	194.55	75.0	75.0
	67.84	77.82	101.75	116.73	169.59	194.55	60.0	60.0
NEW YORK	33.70	52.83	153.12	261.24	186.86	314.07	82.0	83.2
	39.16	60.20	183.32	296.91	217.02	357.11	84.5	83.1
NORTH CAROLINA...	89.28	131.24	63.82	93.82	153.10	225.06	41.7	41.7
NORTH DAKOTA	0	0	168.00	191.00	168.00	191.00	100.0	100.0
OHIO	61.13	67.99	165.27	193.52	226.40	261.51	73.0	74.0
OKLAHOMA	108.00	108.00	92.00	92.00	200.00	200.00	46.0	46.0
OREGON	0	0	141.74	151.80	141.74	151.80	100.0	100.0
- BUBB PLAN [b].	0	0	153.59	168.43	153.59	168.43	100.0	100.0
PENNSYLVANIA	0	0	140.81	165.30	140.81	165.30	100.0	100.0
	0	0	187.92	208.23	187.92	208.23	100.0	100.0
RHODE ISLAND	0	0	235.66	278.13	235.66	278.13	100.0	100.0
SOUTH CAROLINA...	66.02	76.60	67.27	78.03	133.29	154.63	50.5	50.5
	77.88	90.34	67.27	78.03	145.15	168.37	46.3	46.3
SOUTH DAKOTA	123.62	123.62	53.42	59.10	177.04	182.72	30.2	32.3
TENNESSEE	29.22	37.99	116.89	151.96	146.11	189.95	80.0	80.0
TEXAS	88.36	123.59	87.00	102.00	175.36	225.59	49.6	45.2
UTAH	21.82	23.36	196.39	210.25	218.21	233.61	90.0	90.0
VERMONT	30.11	34.09	120.45	136.34	150.56	170.43	80.0	80.0
VIRGINIA	57.00	59.86	139.54	146.52	196.54	206.38	71.0	71.0
WASHINGTON	0	0	183.56	189.08	183.56	189.08	100.0	100.0
WEST VIRGINIA ...	0	0	187.95	188.62	187.95	188.62	100.0	100.0
WISCONSIN [c] ...	28.74	47.84	199.35	226.26	228.09	274.10	87.4	82.5
WYOMING	115.00	112.32	100.00	100.00	215.00	212.32	46.5	47.1

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[b] Rates shown are composite rates.

[c] Contributions vary by benefit plan and by county. State pays lesser of 90% of standard plan rate or 105% of lowest cost HMO in employee's county. Rates shown in table are for standard plan in Dane County (Madison).

Chairman ROSTENKOWSKI. Mr. Calhoun.

STATEMENT OF N. ANTHONY CALHOUN, CONTROLLER, DISTRICT OF COLUMBIA, AND PRESIDENT, NATIONAL ASSOCIATION OF STATE COMPTROLLERS, FOR THE NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS AND TREASURERS

Mr. CALHOUN. Thank you, Mr. Chairman. I am N. Anthony Calhoun, controller for the District of Columbia, and I am testifying as president of the National Association of State Comptrollers which is part of the larger umbrella organization of the National Association of State Auditors, Comptrollers and Treasurers. NASACT, as the name implies, is an association comprised exclusively of over 130 State fiscal officers, approximately half of whom are elected State officials.

Because State comptrollers are the chief accounting officers of their States, the burden of testing compliance with section 89 often falls on them. We are very pleased to have the opportunity to testify today on behalf of State governments and to support the nondiscriminatory objectives of section 89. There are very few, if any, States that have discriminatory employee benefit plans. And unfortunately, perhaps, highly compensated employees are not endemic to State governments.

From a survey that we have recently conducted, there are several questions about the present section 89 that are not addressed in H.R. 1864. The questions involve seven areas, reporting entities, time for compliance, excluded employees, excluded benefits, employee contributions, union agreements, and the District of Columbia as a special entity. I will run through those very quickly.

The reporting entity is very important. State governments consist of three separate but equal branches. Each branch should be tested for compliance as a separate entity. In addition, State legislatures have created specialized boards, commissions, and authorities which have the right to set their own salaries and benefit plans, sometimes within certain limits. Such units should be responsible for their own compliance with section 89.

H.R. 1864 should define "separate lines of business" for governments as it does for the private sector. Nondiscrimination in health and life benefits should apply within each homogenous unit. We would be glad to work with the committee in defining reporting entities within State governments if you would so choose.

Time for compliance. Because some benefit plans are established by State legislatures, they would have to be changed statutorily. Generally, the legislative process is slow and some State legislatures meet only every 2 years. We suggest that governments be given until December 31 of 1991 to comply with section 89 if any of their plans prove to be discriminatory.

As far as excluded employees are concerned, States operate facilities in which prisoners, students, patients and others work while they are incarcerated or studying or under State care. These types of employees should be excluded from testing requirements because they are not covered by benefit plans.

Inactive, former, and retired employees, we feel, should be excluded if they are not entitled to postemployment benefits other than pensions, or if the provider of benefits is not controlled by the employer, such as a statewide trust fund, or where a county or city has employees that earn a statewide fund. All the information and the data is in the statewide fund and is not available for the county and the city to report the information that is required.

We are concerned about the definition of a leased employee. If it means a person who works for a temporary help company, clearly the employer is the temporary help company and not the government. If it means an independent contractor such as an attorney, engineer, consultant, et cetera, the government is still not the employer. In both cases, the testing requirements should be on the employer and not on the government. In both cases, the government treats them as vendors and it would be very difficult to distinguish them from the other vendors.

As far as the excluded benefits, it is not clear as to what constitutes a tuition reduction agreement. Tuition reimbursements to enhance job related skills we feel should be excluded. Physical examinations, if required by the job, such as for police and firefighters, should also be excluded.

Employee contributions. We would like to suggest that the $10 and $25 employee contributions be indexed to increases in medical care costs and not to wage increases which some people that have preceded me have already mentioned. Also as some of my predecessors have mentioned, the $10 and $25 levels might be a little too low.

Part-time employees should be tested separately, we feel because, if part-time employees contribute the same amount as full-time employees, the part-time employee is paying a larger percentage of his or her salary than the full-time employee. So, therefore, they might not meet the $10 and $25 test. For a reduced cost, the part-time employee could be covered for reduced benefits, but I do not think that it is the objective of the committee to reduce the benefits.

As far as union agreements are concerned, we recommend that rather than mandating that union employees are tested separately, the employer be given the option of testing union employees separately or as part of its total workforce. Because some union contracts run for 3 years or more, compliance for union employees should be delayed until a new contract is negotiated. Because each union contract is negotiated separately, there can be no guarantee of uniformity of benefits or contributions.

The District of Columbia has a special problem because a large percentage of its employees are still in the Federal benefit plans. Only those that were hired after October 1, 1987 are in a District-administered plan. And particularly for those who are retired, the information all resides with OPM, so unless they are going to be covered by the Federal Government test, we would have to get the information from OPM. And as some of you may know, those plans, you have open season every year. So those retirees could have changed their plans every year and we have no idea what plan they are in, or even what their current pension is, because their pensions are also indexed.

If H.R. 1864 addresses the foregoing concerns of the State governments, we believe that a more fair and equitable law may result. But our members have a commitment to sound financial planning for their States. This includes a concern for their employees and the provision of equitable health benefits. We do urge the committee to provide additional relief to State and local governments in either the form of further simplification or outright exemption.

Thank you and I would be happy to respond to any questions.

[The statement of Mr. Calhoun follows:]

STATEMENT OF N. ANTHONY CALHOUN, CONTROLLER, DISTRICT OF COLUMBIA AND PRESIDENT NATIONAL ASSOCIATION OF STATE COMPTROLLERS REPRESENTING THE NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS AND TREASURERS

Mr. Chairman, I am Anthony Calhoun, Controller for the District of Columbia. I have served as Controller since September, 1984.

I am testifying today as President of the National Association of State Comptrollers which is part of a larger umbrella organization, the National Association of State Auditors, Comptrollers and Treasurers. NASACT, as the name implies, is an association comprised exclusively of over 130 statewide fiscal officers, approximately half of which are elected state officials.

In general, state comptrollers maintain the accounting system for their state and control expenditures against budgeted amounts. Most of them also set accounting principles and issue financial statements. In addition, thirty-seven state comptrollers handle payroll, which explains their interest in Section 89. Because they handle payroll deductions for benefits and because they know how much employees earn, they are the most logical source of information that a state would need to determine whether it complies with the provisions of Section 89.

We are very pleased to have the opportunity to testify today as part of the public sector. We support the nondiscriminatory objectives of Section 89 of the Internal Revenue Code, but on the basis of preliminary survey results from our members, the majority of state fiscal officers find the present law too complex and too burdensome.

Let me reassure you, Mr. Chairman, I do not intend to focus my testimony today on the shortcomings of the Section 89 law currently in effect. However, in order to share the results of an informal survey of the members of the National Association of State Comptrollers , it is necessary to note that the questions on the survey mailed on April 4 pertain to the current Section 89 law and not H.R. 1864.

The survey that was mailed to the National Association of State Comptrollers revealed several problems that both apply to the current Section 89 law and remain unresolved in H.R. 1864. One of these problems concerns the different entities that make up state government.

State governments are not readily defined as a single entity and, in fact, are not governed as a single entity. The checks and balances inherent in state governments' structures make it difficult to clearly define what constitutes an entity. Each branch of government must, of necessity, maintain a certain amount of autonomy. The legislature sets some welfare plan policies, which must be implemented by the executive branch, and are then subject to judicial rulings. As you know, a legislative body does not take kindly to being told by the executive branch to conform to this or that administrative requirement, and I submit that it is incumbent upon us to recognize the unique structure of government.

What is needed is an approach that addresses the unique structure of government. Your bill should indentify "separate lines of business" for state governments, as it does for the private sector. Under a similar provision for state governments, independent personnel authorities created by the legislature, could be tested as a separate entity. Examples would be a police force, or a hospital, or a convention center authority. We would be happy to work with the Committee on specific language in this area.

The structure of government also makes it necessary to give us a little more time to comply with the provisions of H.R. 1864. Because some welfare plan provisions are established by state legislatures, and would have to be changed statutorily, I would ask that you allow states two years beyond January 1, 1990 to comply with the provisions of your bill. This would recognize that some state legislatures only meet every two years.

Time is also a problem with union contracts. The law should be amended so that provisions dealing with union contracts will not take effect until the end of the next renegotiation. This is not the case currently.

Another unique problem of state and local governments involves state-run facilities, such as prison systems. Obviously, private enterprises do not have to include prisoners when testing their welfare benefit plans for non-discrimination requirements. More than one survey response indicated that this is an area that needs to be addressed. We believe prisoners, students in work study programs and clients in health institutions should be excluded from testing requirements.

For other practical reasons we also believe that inactive, former employees and retired employees should be excluded. It would be extremely difficult to run tests on such personnel because they are not in the current payroll system and cannot be easily identified.

H.R. 1864 represents a major step forward with regard to simplifying Section 89. We have some serious concerns, however, with parts of the bill. The concerns center on maximum employee contributions, part-time employees, and the treatment of union employees.

Limiting employee contributions to $10.00 per week for employee-only coverage and $25.00 per week for family coverage represents a commendable effort to make health coverage affordable. While it may be feasible to offer coverage with employee contribution rates at this level for the near future, although this is doubtful in certain regions of the country, it is not realistic in the long term. The reason is because H.R. 1864 indexes the dollar amounts to wage growth. The problem is that medical care costs are rising faster than wages.

According to the Bureau of Labor Statistics, wages increased 4.2% for the year ended March 1989, while medical care costs increased 7.2% for the same time period. In addition, the cost of welfare benefit plans is also rising. Benefit costs increased 5.4% for the year ended March 1989.

What this means then, is that while medical care costs continue to soar and the cost of benefit plans continues to increase, wages will not increase fast enough to pay for the employee's share of benefits. When this happens, government employers will be obliged to increase their subsidization of health care plans in order to comply with H.R. 1864. This could end up being quite an expensive proposition for state and local governments.

The second issue pertains to part-time employees. Many members indicated on the survey that the current rule to consider employees who work less than 17 and-a-half hours per week is unrealistic. H.R. 1864 addresses the problem by increasing the ceiling to 25 hours. While we feel this is a step in the right direction, it is still a disincentive for hiring part-time people.

Government employers, as well as private enterprises, are confronted with a changing workforce. There are people in the workplace, such as working mothers, who want to work part time and are covered by a spouse's health plan. It is uneconomical to pay the same amount for insurance for a person working 25 hours per week as it is for a person working 40 hours per week. It is also discriminatory in that part-time workers would, in fact, be subsidized to a greater degree than full time workers. In the long run, this provision could reduce incentives to hire part-time workers.

There are a number of provisions in H.R. 1864 that need further clarification. The foremost of these is the special rule regarding the treatment of union employees.

We would like to suggest that rather than mandating that union employees be treated separately, that this be an option. Government employers are likely to have a large diversity of occupations among employees along with many different unions. It may be more logical when testing to group certain types of employees together, whether union or non-union.

Further, the bill provides that union employees are tested separately if, "not more than a de minimus number of employees in such unit perform services in the field of health..." In some states, government employers have unionized health workers. Would these unions still be tested separately? We feel the language needs further clarification.

Other issues in need of clarification are "leased employees" and tuition reduction agreements. I would like to touch briefly on each of these areas.

The problem with testing leased employees for state and local governments is that the employees are not identifiable in the payroll system. They are paid by the leasing company and thus should be tested by the leasing company. It should not be the responsibility of governments to oversee this procedure.

Clarification regarding tuition reduction agreements is needed to spell out exactly what is meant by tuition. How should it be tested? Is a conference fee a tuition? We would like to exclude tuition reduction agreements from the "fringe" benefits to be tested.

While some of these issues may not have been raised in the testimony from the private sector, Mr. Chairman, they are important issues regarding state government. I talked earlier about comparing state and local governments with the private sector and noted some differences. Now I would like to give you some specific examples of how these differences impact our personnel.

Welfare benefit plans as well as retirement plans are hiring incentives at a time when state and local governments can ill afford to boost salaries. In an era of rampant drug-related crime, we need to attract highly-qualified law enforcement and public safety personnel. These people are risking life and limb for society's benefit and should include excellent health and life insurance benefits -- benefits that are superior to those provided to personnel working in a safer environment. If these personnel were to be taxed on benefits, it would be a disincentive for those currently in the law enforcement profession or considering entering the profession.

There is a basic fairness issue here, and I can give you another example. Many state and local jurisdictions require regular physical examinations for public safety employees. These physical examinations are provided free of charge to determine if employees are fit to perform their duties. We believe that if a physical exam is part of a job requirement it should be excluded from benefits testing.

Lastly, I would like to talk about a special problem with regard to the District of Columbia and Section 89. Up to and through September 30, 1987 District employees were included in the Federal health and life insurance programs. Employees hired after that date are covered by health plans administered by the District government. How do we test those employees covered by the federal program? They are indeed employed by the District of Columbia, but they are enrolled in federal plans.

Before I conclude my testimony, Mr. Chairman, I would like to include some of the results of our survey. Some of the suggestions and problems I have already discussed above are included in these results as well as additional information.

NATIONAL ASSOCIATION OF STATE COMPTROLLERS' SECTION 89 SURVEY

As I said, a very brief survey was mailed to members of the National Association of State Comptrollers on April 4. We conducted the survey to obtain informal answers about such things as:

* suggestions as to how to simplify the law for state and local governments;
* how much individual states expect to spend on consulting/ start-up costs; and,
* soliciting questions and comments on the regulations.

Because the questions asked were deliberately open-ended, we received a wide variety of suggestions and comments. The data is preliminary and is still being compiled.

Simplification

The most frequent reply as to how to simplify the law was to provide some kind of exemption to state and local governments. This is not a surprising response considering the fact that some states provide similar coverage to all employees. The state of Vermont, for instance, stated that out of 8,000 employees there are 60 that are highly compensated! Further, the benefits that these 60 people receive are exactly the same as the other Vermont employees.

Nebraska expressed a similar view pointing out that there are state statutes pertaining to the health and life insurance plans to safeguard the rights of permanent employees and that some type of exemption should be awarded Nebraska. The comproller's office here went on to express confusion over certain testing requirements and labeled the Code and regulations as "impossible" to understand.

There were other thoughtful responses. Connecticut recommended a study be conducted of state legislation regarding employee benefits to determine if there was a need to impose Section 89 requirements on state governments. This approach would necessarily delay implementation of Section 89 regulations, but could ultimately save states a considerable amount of time and money in evaluating and testing. Another state advocated the concept of aggregating plans and yet another suggested that prisoners of federal, state and local penal institutions should be excluded as employees.

There was one response in particular I thought especially noteworthy. The state of Illinois wrote that, "...since most government health, life and accident insurance programs are offered equally to all employees (i.e., non-discriminatory), governments should be deemed to be in compliance with Section 89 unless demonstrated otherwise." The comptrollers' office here further stated that, "Any cases of discrimination could be referred and investigated on a government-by-government basis. Governmental entities which undergo Federal "single audits" could be examined for possible impropriety as part of the scope of the single audit."

Consulting/Start-Up Costs

The majority of states responding to this question indicated they have already contracted with, or will contract with a consultant to assist them in complying with the current law. These estimated costs, for consulting and start-up, ranged from $37,000 to $1,176,000. This difference in costs reflects the variations in computer equipment and software and the number of employees. Some states are still undecided as to whether to hire a consultant because they are unsure of the scope of services needed.

Comments on the Regulations

The most frequent comment on the regulations was that they are too complex. When asked if states had specific questions about the Section 89 law that were not answered in the regulations, responses varied widely. There was some confusion as to who the employer is. For instance, it was noted that colleges and universities and affiliated hospitals establish their own compensation system and contract for benefit plans, but in a broad sense these employees are government employees. Other questions included:

* How do you determine who is a "leased employee"?
* How do you test group term life insurance?
* How do you determine excludable employees and excludable former employees?

As I indicated earlier, many answers expressed frustration and confusion with the regulations. Some commented on the lateness in the year and the fact that the regulations were incomplete.

In conclusion, Mr. Chairman, I would like to say that our members have a commitment to sound financial planning for their states. This includes a concern for their employees and the provision of equitable health benefits. We urge the Committee to provide additional relief to state and local governments in the form of further simplification or exemption.

Thank you, Mr. Chairman. I would be happy to respond to questions.

Mr. RUSSO [presiding]. Thank you very much, Mr. Calhoun.
Mr. Thomas.

STATEMENT OF RICHARD THOMAS, DIRECTOR, BENEFITS DEPARTMENT, SCHOOL BOARD OF BROWARD COUNTY, FL, FOR THE AMERICAN ASSOCIATION OF SCHOOL ADMINISTRATORS

Mr. THOMAS. Thank you, Mr. Chairman. My name is Richard Thomas. I am the director of benefits for the school board of Broward County which is located in Fort Lauderdale. I am pleased to have this opportunity to testify before this committee on behalf of the American Association of School Administrators. This association represents 19,000 school superintendents across this country as well as other school officials.

With respect to my school district in Broward, we have the Nation's largest accredited school system. We serve approximately 170,000 students. We have 16,000 full-time employees, 4,000 part-time employees; 85 percent of our employees bargain collectively.

My brief comments relate to past compliance efforts and are basically historical. We have considerable concern with H.R. 1864, particularly the affordability criteria spelled out in the legislation. Over the past year a number of school districts have attempted to comply with discrimination testing and a number of concerns have arisen among these districts. Some of those concerns might be unique to school boards.

By and large, educational risk managers, feel that testing regulations proposed would be too difficult to address, too complex within the parameters of the law, and we welcome the changes that would be afforded under H.R. 1864.

In Broward County the health care crisis in south Florida drove us to bid all of our insurance contracts this past year. This made it impossible to test until October of this year. About $40 million in insurance programs were bid out. Massive changes in enrollment and other changes exacerbated the problem.

The cost of testing continues to concern all of the school districts. At the very least we know that testing will cost us thousands of dollars, district money that might be spent better in education. In the past our estimates in Broward were $60,000 to $80,000 to do the actual discrimination testing. In neighboring Dade County, in Miami, their estimates are around $100,000. Even in Takoma, WA, in a small district with only 3,500 pupils the cost will be between $13,000 and $16,000.

We recognize that the data acquisition has to be performed inhouse, and this is a perplexing problem that we look to and hopefully we will have some relief. Most school districts do not, indeed, have very sophisticated information service departments, unlike the Fortune 500 companies, and smaller districts are much like small businesses.

Additionally, most large districts like mine have moved into cafeteria programs under section 125 with widely varied designs. These serve bus drivers and varied employees that are found in a school district from cafeteria workers on through tradesmen, a wide range of employees other than the instructional employees that are normally thought of as working for a school board. Data concerning these complex plans quite often are not found in our databases. In Dade County we found that the third-party administrator retained most of the data that would have been necessary to fulfill the testing requirements.

The recently issued proposed regulations by the IRS on both section 89 and section 125 are a matter of great concern. We find that they have an immediate impact on our cafeteria plan where the flexible spending accounts are going to change dramatically. They will have to assume the risk characteristics of insurance, and we will have an immediate cash-flow impact of about $1.5 million on my district alone.

The American Association of School Administrators does indeed support the idea of nondiscriminatory benefits for employees. Most school districts do not discriminate in terms of uniform benefits offered and often offer a broader range of uniform benefits than most other businesses.

We applaud this committee and the chairman for offering legislation that would significantly simplify the testing requirements. However, I must say that in Broward County, as with other south Florida districts, we would fail the discrimination tests. As an earlier panel member immediately preceding panel from California mentioned, the Broward School Board pays all of the individual's costs. We have a wide range of benefits. We pay 31 percent of salary in benefits and yet we do not contribute dependent premium. We automatically would fail. We do not see any relief in H.R. 1864.

Returning to the American Association of Administrators, they do indeed greatly appreciate the fact that the legislation would increase the minimum hours for part-timers from 17½ to 25 hours per week—the 25-hour standard. We have been advised that the intention is that these hours be considered on an annual basis. However, nothing in the bill exists that would prevent misinterpretation when the regs are written.

Because the number of hours an employees works on a given testing day or during a particular week may not be representative of the average hours worked annually, the American Association of School Administrators would like this to be clarified in the bill's language to state that an annual total of 25 hours per week over a 52-week period, or 1,300 hours is the minimum number of hours an employee would have to work in order not to be excluded from section 89 provisions. We ask that you incorporate our recommendation in your legislation.

I would like to thank you for your efforts to improve section 89 and for allowing us this privilege of testifying. Thank you.

[The statement of Mr. Thomas follows:]

TESTIMONY OF THE AMERICAN ASSOCIATION OF SCHOOL ADMINISTRATORS

Introduction

Chairman Rostenkowski and distinguished members of the Committee: My name is Richard Thomas and I am Director of the Benefits Department for Broward County Public Schools in Fort Lauderdale, Florida. I am pleased to have this opportunity to testify before the House Ways and Means Committee on behalf of the American Association of School Administrators (AASA), representing 19,000 school superintendents and other school officials across the nation.

Broward County Public Schools is the eighth largest school district in the country. It is the nation's largest fully accredited school district. We serve 150,000 students and employ 16,500 full time employees and several thousand part time employees.

Background

Proposed regulations regarding Section 89 of the Internal Revenue Code, as modified under the 1986 tax bill, were intended to eliminate the tax-favored treatment of employer-provided benefits for highly compensated employees. The Small Business Administration conducted a study that showed that most of the working uninsured are found in small businesses and the effect of the legislation, thus far, has been that many small businesses have dropped all benefits.

School districts all over the country are being deluged with calls and correspondence from lawyers and consulting firms offering to test benefit packages. A number of concerns have arisen as districts have attempted to comply. Some of these are unique to school districts; others are not.

In meeting the qualification requirement of written notice alone, school districts have found that reinsurers are not always willing to provide information. If they refuse to provide necessary information, we do not know what recourse school districts have. A school official from Detroit, Michigan, reported that their districts have approximately 3000 variations in benefits programs.

Problems with Testing Requirements

First of all, nondiscrimination testing, as proposed in the regulations, is too complex to accomplish within the framework of deadlines established. In addition, because of uncertainties, ambiguities, complexities, and tardiness of the publication of regulations, few districts have begun to test. This has further shortened the time available. An informal telephone survey among members of the Florida Educational Risk Managers Association showed that the majority have not begun nondiscrimination testing. In Broward County, we changed all our employee benefit programs on March 1. Employee enrollment in various plans shifted and dependents were added and deleted during that time, making it absolutely impossible to test the school board's plans any earlier than October 1, 1989.

Second, testing is estimated to cost several thousand dollars in large school districts--money that is sorely needed for educating children. In Broward County alone, it is estimated that, under the proposed regulations, it would cost $60,000 to 80,000 to satisfy testing requirements. In Dade County, Florida, it would cost approximately $100,000. Even in the Tahoma, Washington school district, with only 3500 students, testing is estimated at $13,000 to $16,000.

As we have begun to investigate what is required under this law, we have found that estimates of the costs of conducting discrimination tests and of determining excess benefits are easy to calculate with data in hand. However, it is difficult to assess internal costs to format and obtain all the data that are required in order to conduct the tests. While costs of testing can be contracted out, data acquisition must be accomplished internally. This promises to be a difficult and expensive task. Certainly, this was not the intention of Congress in passing the legislation.

Third most information services departments in school districts are not at all sophisticated, as are those in large Fortune 500 companies. Small school districts do not have information services departments at all and are experiencing some of the same problems as small businesses.

Fourth, many large school districts have complex benefit plans with widely varied plan designs. This is to accommodate different classes and earning potentials of employees, such as cafeteria plans with high-low options. Data concerning these complex offerings are not necessarily available. In Dade County, for example, some data were found only in the data bank of the third party administrator because of their cafeteria plan contract.

Fifth, flexible spending accounts (FSAs), part of cafeteria plans, are affected by this legislation, seriously impacting the cash flow of school boards and costing them additional money.

Sixth, school boards are unique in that they employ dozens of specialty employees, in addition to teachers. Tradesmen, bus drivers, clerical staff, and cafeteria workers may all be represented through separate collective bargaining agreements, resulting in varying contracts and benefits packages, which are often tailored to meet the needs of these different classes of employees. The school district in Grand Rapids, Michigan has 16 different employee groups who all bargain separately.

Seventh, Section 89 discourages employers from offering incentives to couples to have only one health plan between them. In Grand Rapids, health plan costs approximately $3600 annually, and the second plan presents limited benefits. That district has offered annuity plans as alternatives to the second health plan at less expense to the employer and greater benefit to the employee. This legislation discourages them from doing so.

Eighth, school districts have different work calendars for their different employees. In Broward County, they range from 196 days through 256 days. This further exacerbates the problem of trying to conduct discrimination tests. Also, unlike other employers, school boards employ substitute teachers. Inclusion of these particular part time employees in testing would greatly distort testing results and would cause districts to fail nondiscrimination tests.

Ninth, and lastly, school boards, like most public sector employers, are viewed as having deep pockets. If we solve the riddle of accomplishing the yet-to-be-decided testing requirements, there is the question of liability from lawsuits or class action suits from employees who might challenge the data. This either makes school business managers liable or, if work is contracted out, CPA or law firms, at tremendous cost to school districts.

AASA's Position

AASA supports the idea of nondiscriminatory benefits for employees. Most school districts do not discriminate in terms of benefits offered and are more generous than other businesses. AASA also supports repeal of Section 89 legislation, as the proposed regulations do not have the potential to achieve the important public policy objective sought by this measure. We applaud the Chairman for offering legislation that would significantly simplify testing requirements. We anticipate that H.R. 1864 would serve to significantly simplify testing requirements. In Broward County, we have a comprehensive benefit plan for our employees (see Appendix). However, we do not cover dependents but, rather, have a dependent option, costing the employee far more than the maximum of $25 per week proposed by the Chairman's bill. This provision alone would cause Broward County to fail the proposed test.

We appreciate the fact that this legislation would increase the minimum hours for part time employees from 17 1/2 hours per week to 25 hours per week. Although we are told that the intention is that these hours be considered on an annual basis, there is nothing in the bill that would prevent a misinterpretation of the language when regulations are written, which states that excluded employees include those "who normally work less than 25 hours per week."

Because the number of hours an employee works on a given testing day or during a particular week may not be representative of the average number of hours worked on an annual basis, **AASA would like this to be clarified in the bill's language to state that an annual total of 25 hours per week over a 52 week period, or 1300 hours, is the minimum number of hours an employee would have to work in order not to be excluded from Section 89 provisions.** Variations in length of employee contracts and variety of specialty workers, including substitute teachers, discussed as unique problems of school districts, combined with ambiguity in the bill's language could lead to misinterpretation that would have devasting effects on school districts. We ask that you incorporate our recommendation in your legislation.

Thank you for your efforts to improve Section 89 and for allowing us this opportunity to testify before the Committee.

Mr. RUSSO. Thank you, Mr. Thomas.

Mr. Terry Wood from the National Association of Counties.

STATEMENT OF TERRY R. WOOD, CHAIRMAN, PENSION AND EMPLOYEE BENEFITS SUBCOMMITTEE, PRESIDENT, JACKSONVILLE-DUVAL COUNTY, FL, GOVERNMENT, FOR THE NATIONAL ASSOCIATION OF COUNTIES

Mr. WOOD. Thank you, Mr. Chairman. Thank you for the opportunity to testify. I am Terry Wood, president of the Jacksonville-Duval County Council in Florida and chairman of the labor and employee benefits subcommittee of the National Association of Counties. I am delighted to appear on behalf of NACO to share with you and the members of the committee the problems that section 89 has imposed on counties and our views on the proposed simplification bill, H.R. 1864.

Let me start by stating our position on section 89. We strongly support State and local government exemption from section 89 for three reasons. We do not discriminate in providing benefits to our employees. There are safeguards in the public sector to protect against discrimination. And we are legally responsible for providing health care services to the uninsured. In the public sector, section 89 will only limit our ability to provide flexible benefit options to our employees and significantly increase the cost to taxpayers.

The purpose of section 89 is unclear to us. We are not sure if it was intended to raise revenues, or to extend health coverage, or to discourage discrimination. In any case, we are not convinced that section 89 was the best approach. For the sake of simplicity, many have testified that a cap on tax-exempt benefits, which allows for some regional flexibility in costs, would be a much better approach. Under this approach, benefits above a certain level would be taxed as income.

In general, we feel the proposed section 89 simplification bill represents an improvement over current law. It proposes to reduce data collection and reporting requirements, replace the complicated nondiscrimination test with a simplified test, exempt part-time workers who work under 25 hours, delay the implementation of the rules for 1 year, and eliminate the financial penalties on rank and file employees. While these changes would make compliance much easier, there are a few provisions in the bill that would make it more difficult for us to pass under the new simplified nondiscrimination test.

Under the proposed legislation, the special rule for salary reduction and the limit on employee costs for family coverage would make the simplified test difficult to pass for counties that offer flexible spending programs to their employees. Under the special rule, any contribution through a salary reduction arrangement must be treated as an employer contribution for highly compensated employees. And highly compensated is a difficult concept in the public sector. In my city, a police captain who is in a bargaining unit that bargains with us is making over $50,000 a year as base salary and he would be a highly compensated employee by your definition.

The employer's contribution must not exceed 133 percent of the smallest contribution for rank and file employees. This would present a problem for many counties, particularly those who pay 100 percent of the individual coverage and allow their employees to pay for all or a portion of the cost for any added family coverage under a salary reduction arrangement.

In many cases these additional costs will exceed the 133 percent limit in these rules. For example, if a county employer pays $100 a month to provide individual health coverage for all of its employees but requires them to pay $50 a month for additional family coverage through a salary reduction arrangement, the highly compensated employees will cause the county to fail the test. In this case it is the rules, not the practice, that would cause the plan to be discriminatory. The accounting would indicate that the employer provides $150 a month for its highly compensated employees, but only $100 a month for its nonhighly compensated employees, although the actual dollar burden is the same. This type of arrangement is common among our counties.

Under the special rule for salary reduction, we stand to fail the simplified nondiscrimination test, not because we discriminate but because passing it depends on the value of the benefits that our highly compensated employees may select under a salary reduction arrangement. Because of the diversity of needs among our employees, it would be almost impossible to pass the test if our highly compensated employees participate in these plans.

Although we are unsure if the sponsors of the proposed legislation intended it, flexible benefits may have to be eliminated as an option for our employees. If this should happen, it would be unfortunate because we have developed our benefit plans over the years to respond to the diversity of needs in our workforce. By exempting State and local governments from section 89, not only will our employees be able to receive flexible benefits, but we will be able to save the taxpayers millions of dollars in added costs associated with compliance.

As public employers we have historically offered simple and uniform benefit plans to elected, appointed and civil service employees. In a 1987 report the Bureau of Labor Statistics found that 94 percent of full-time employees in State and local governments have medical insurance coverage and 85 percent have life insurance coverage. The report further shows in the majority of cases state and local governments pay the full cost for individual coverage. In 27 percent of the cases it shows that we pay the full cost of family coverage, and in an additional 66 percent of the cases we pay a portion of the cost for family coverage.

In light of these facts, Mr. Chairman, we are convinced that the application of section 89 to State and local governments is unnecessary. In fact, it will result in a disservice to our employees and increased costs to our taxpayers.

Counties are not merely public employers though. We provide a full range of vital public services to our residents including health care, education, law enforcement, firefighting, courts, maintenance of roads and bridges, and nursing homes. As service providers, we maintain over 1,000 health care facilities across the nation including county hospitals and nursing homes. We spend a significant amount of revenues each year to provide health care to uninsured indigents. For many of us, this is one of our highest, if not the highest, annual costs for county service.

The 1986 Bureau of the Census report shows that counties spent $14.9 billion on health care services. It also identifies $7.2 billion in uncompensated health care costs for hospital services. While these costs represent the total loss for public and private hospitals, it is safe to assume that the vast majority of these costs were borne by county hospitals since private hospitals usually refer uninsured patients to our facilities.

One of the primary safeguards against discrimination in the public sector is the electoral process. Every 2 to 4 years our votes, including our employees, hold us accountable for decisions we make in public policy. In Florida, our voters do not mind letting us know when they think our decisions were a mistake.

Another safeguard available in many areas is the collective bargaining process which involves public employers reaching agreement with union representatives of their employees on pay, benefits and working conditions. Benefits under union agreements are mutually accepted by both the employer and their employees.

The last safeguard I will mention to you is the responsibility of the care for those uninsured indigents. In 31 States we are mandated by law to provide health care services to uninsured indigents. We also feel, just to wrap up, that when private sector employers drop health insurance for their employees, they will turn to our facilities seeking much of their health care and that has us greatly concerned.

In summary, Mr. Chairman, we believe that H.R. 1864 would simplify the existing section 89 nondiscrimination rules. We believe these rules should be applied to areas where broad-based discrimination exists. They should not be applied to public employers who have traditionally offered the same level of benefits to all their employees and who have safeguards in place to protect against discrimination.

Thank you.

[The statement of Mr. Wood follows:]

STATEMENT OF THE HONORABLE TERRY R. WOOD, PRESIDENT JACKSONVILLE-DUVAL COUNTY, FLORIDA ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES

THANK YOU FOR THE OPPORTUNITY TO TESTIFY MR. CHAIRMAN. I AM TERRY WOOD, PRESIDENT OF THE JACKSONVILLE-DUVAL COUNTY COUNCIL IN FLORIDA AND CHAIRMAN OF THE PENSION AND EMPLOYEE BENEFITS SUBCOMMITTEE OF THE NATIONAL ASSOCIATION OF COUNTIES (NACo)*. I AM DELIGHTED TO APPEAR ON BEHALF OF NACo TO SHARE WITH YOU AND MEMBERS OF THE COMMITTEE, THE PROBLEMS THAT SECTION 89 HAS IMPOSED ON COUNTIES AND OUR VIEWS ON THE PROPOSED SIMPLIFICATION BILL, HR 1864.

LET ME START BY STATING OUR POSITION ON SECTION 89. WE STRONGLY SUPPORT STATE AND LOCAL EXEMPTION FROM SECTION 89 FOR THREE REASONS. WE DO NOT DISCRIMINATE IN PROVIDING BENEFITS TO OUR EMPLOYEES. THERE ARE SAFEGUARDS IN THE PUBLIC SECTOR TO PROTECT AGAINST DISCRIMINATION. AND WE ARE LEGALLY RESPONSIBLE FOR PROVIDING HEALTH CARE SERVICES TO THE UNINSURED. IN THE PUBLIC SECTOR, SECTION 89 WILL ONLY LIMIT OUR ABILITY TO PROVIDE FLEXIBLE BENEFIT OPTIONS TO OUR EMPLOYEES AND SIGNIFICANTLY INCREASE THE COST TO TAX PAYERS.

IF THERE ARE EMPLOYERS USING TAX-EXEMPT BENEFITS DISCRIMINATELY IN FAVOR OF THEIR TOP PAID EXECUTIVES, WE CAN UNDERSTAND WHY A CHANGE IN THE TAX RULES IS NECESSARY. HOWEVER, WE BELIEVE THE RULES SHOULD BE CAREFULLY CONSTRUCTED TO CORRECT AND DISCOURAGE DISCRIMINATION WHERE IT EXIST. THEY SHOULD NOT RESTRICT THE ABILITY OF PUBLIC SECTOR EMPLOYERS TO OFFER FLEXIBLE BENEFIT PLANS TO THEIR EMPLOYEES.

THE PURPOSE OF SECTION 89 IS UNCLEAR TO US. WE ARE NOT SURE IF IT WAS INTENDED TO RAISE REVENUES OR EXPAND HEALTH COVERAGE OR DISCOURAGE DISCRIMINATION. IN ANY CASE, WE ARE NOT

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* THE NATIONAL ASSOCIATION OF COUNTIES IS THE ONLY NATIONAL ORGANIZATION REPRESENTING COUNTY GOVERNMENT IN THE UNITED STATES. THROUGH ITS MEMBERSHIP, URBAN, SUBURBAN AND RURAL COUNTIES JOIN TOGEHTER TO BUILD EFFECTIVE, RESPONSIVE COUNTY GOVERNMENT. THE GOALS OF THE ORGANIZATION ARE TO: IMPROVE COUNTY GOVERNMENT; SERVE AS THE NATIONAL SPOKESMAN FOR COUNTY GOVERNMENT; ACT AS A LIAISON BETWEEN THE NATION'S COUNTIES AND OTHER LEVELS OF GOVERNMENT; ACHIEVE PUBLIC UNDERSTANDING OF THE ROLE OF COUNTIES IN THE FEDERAL SYSTEM.

COUNTY TO FAIL THE TEST. IN THIS CASE, IT IS THE RULES NOT THE PRACTICE THAT WOULD CAUSE THE PLAN TO BE DISCRIMINATORY. THE ACCOUNTING WOULD INDICATE THAT THE EMPLOYER PROVIDES $150 PER MONTH FOR ITS HIGHLY COMPENSATED EMPLOYEES, BUT ONLY $100 PER MONTH FOR ITS NON-HIGHLY COMPENSATED EMPLOYEES, ALTHOUGH THE ACTUAL DOLLAR BURDENS ARE THE SAME. THIS TYPE OF ARRANGEMENT IS COMMON AMONG COUNTY EMPLOYERS.

UNDER THE SPECIAL RULE FOR SALARY REDUCTION, WE STAND TO FAIL THE SIMPLIFIED NONDISCRIMINATION TEST NOT BECAUSE WE DISCRIMINATE BUT BECAUSE PASSING IT DEPENDS ON THE VALUE OF BENEFITS THAT OUR HIGHLY COMPENSATED EMPLOYEES MAY SELECT UNDER A SALARY REDUCTION ARRANGEMENT. BECAUSE OF THE DIVERSITY OF NEEDS AMONG OUR EMPLOYEES, IT WOULD BE ALMOST IMPOSSIBLE TO PASS THE TEST IF OUR HIGHLY COMPENSATED EMPLOYEE PARTICIPATE IN FLEXIBLE PLANS. ALTHOUGH WE ARE UNSURE IF THE SPONSORS OF THE PROPOSED LEGISLATION INTENDED IT, FLEXIBLE BENEFITS MAY HAVE TO BE ELIMINATED AS AN OPTION FOR OUR EMPLOYEES. IF THIS SHOULD HAPPEN, IT WOULD BE UNFORTUNATE BECAUSE WE HAVE CAREFULLY DEVELOPED OUR BENEFIT PLANS OVER THE YEARS TO RESPOND TO THE DIVERSITY OF NEEDS IN OUR WORK FORCE. BY EXEMPTING STATE AND LOCAL GOVERNMENTS FROM SECTION 89, NOT ONLY WILL OUR EMPLOYEES CONTINUE TO RECEIVE FLEXIBLE BENEFITS, BUT WE WILL SAVE THE TAXPAYERS MILLIONS OF DOLLARS IN ADDED COSTS ASSOCIATED WITH COMPLIANCE.

LET ME PROVIDE YOU WITH A FEW BASIC FACTS ABOUT COUNTIES TO HELP YOU UNDERSTAND WHY WE STRONGLY FAVOR EXEMPTION FROM SECTION 89. THERE ARE 3,106 COUNTIES ACROSS THE NATION IN ALL STATES EXCEPT CONNECTICUT AND RHODE ISLAND. THEY VARY GREATLY IN DEMOGRAPHICS AND WEALTH. ABOUT THREE-FOURTH OF ALL COUNTIES HAVE A POPULATION OF LESS THAN 50,000. OUR SMALLEST COUNTY IS LOVING COUNTY, TEXAS WHICH HAS A POPULATION OF 87 AND OUR LARGEST COUNTY IS LOS ANGELES COUNTY, CALIFORNIA WHICH HAS A POPULATION OF OVER 8,000,000. IF WE USE THE AVERAGE ANNUAL INCOME REPORTED IN THE

CONVINCED THAT SECTION 89 WAS THE BEST APPROACH. FOR THE SAKE OF SIMPLICITY, MANY HAVE TESTIFIED THAT A CAP ON TAX-EXEMPT BENEFITS, WHICH ALLOWS FOR SOME REGIONAL FLEXIBILITY IN COSTS, WOULD BE A MUCH BETTER APPROACH. UNDER THIS APPROACH, BENEFITS ABOVE A CERTAIN LEVEL WOULD BE TAXED AS INCOME.

IN GENERAL, WE FEEL THE PROPOSED SECTION 89 SIMPLIFICATION BILL (HR 1864), REPRESENTS AN IMPROVEMENT OVER CURRENT LAW. IT PROPOSES TO REDUCE DATA COLLECTION AND REPORTING REQUIREMENTS, REPLACE THE COMPLICATED NONDISCRIMINATION TESTS WITH A SIMPLIFIED TEST, EXEMPT PART-TIME WORKERS WHO WORK UNDER 25 HOURS, DELAY THE IMPLEMENTATION OF THE RULES FOR ONE YEAR AND ELIMINATE THE FINANCIAL PENALTY FOR RANK AND FILE EMPLOYEES. WHILE THESE CHANGES WOULD MAKE COMPLIANCE MUCH EASIER, THERE ARE A FEW PROVISIONS IN THE BILL THAT WILL MAKE IT MORE DIFFICULT FOR US TO PASS THE NEW SIMPLIFIED NONDISCRIMINATION TEST.

UNDER THE PROPOSED LEGISLATION, THE SPECIAL RULE FOR SALARY REDUCTION AND THE LIMIT ON EMPLOYEE COSTS FOR FAMILY COVERAGE WOULD MAKE THE SIMPLIFIED TEST DIFFICULT TO PASS FOR COUNTIES THAT OFFER FLEXIBLE SPENDING ACCOUNTS TO THEIR EMPLOYEES. UNDER THE SPECIAL RULE, ANY CONTRIBUTION THROUGH A SALARY REDUCTION ARRANGEMENT MUST BE TREATED AS AN EMPLOYER CONTRIBUTION. FOR HIGHLY COMPENSATED EMPLOYEES, THE EMPLOYER'S CONTRIBUTION MUST NOT EXCEED 133 PERCENT OF THE SMALLEST CONTRIBUTION FOR RANK AND FILE EMPLOYEES. THIS WOULD PRESENT A PROBLEM FOR MANY COUNTIES, PARTICULARLY THOSE WHO PAY 100 PERCENT FOR INDIVIDUAL COVERAGE AND ALLOW THEIR EMPLOYEES TO PAY FOR ALL OR A PORTION OF THE COST FOR ANY ADDED FAMILY COVERAGE UNDER A SALARY REDUCTION ARRANGEMENT.

IN MANY CASES THESE ADDITIONAL COSTS WILL EXCEED THE 133 PERCENT LIMIT IN THE RULES. FOR EXAMPLE, IF A COUNTY EMPLOYER PAYS $100 PER MONTH TO PROVIDE INDIVIDUAL HEALTH COVERAGE FOR ALL OF ITS EMPLOYEES BUT REQUIRES THEM TO PAY $50 PER MONTH FOR ADDITIONAL FAMILY COVERAGE THROUGH A SALARY REDUCTION ARRANGEMENT, THE HIGHLY COMPENSATED EMPLOYEES WILL CAUSE THE

1986 CENSUS DATA AS A MEASURE OF WEALTH, COUNTIES WOULD VARY FROM A LOW OF $3,374.00 IN STARR COUNTY, TEXAS TO A HIGH OF $23,161.00 IN FAIRFAX COUNTY, VIRGINIA.

THE MAJOR SOURCE OF REVENUE FOR MOST COUNTIES IS THE PROPERTY TAX AND IN ALMOST ALL CASES WE ARE LIMITED BY STATE LAW ON THE AMOUNT WE MAY ASSESS ON AN ANNUAL BASIS. CONSEQUENTLY, WE DO NOT HAVE A LOT OF ROOM FOR FLEXIBILITY IN OUR BUDGETS.

AS PUBLIC EMPLOYERS, WE HAVE HISTORICALLY OFFERED SIMPLE AND UNIFORM BENEFIT PLANS TO BOTH OUR ELECTED, APPOINTED AND CIVIL SERVICE EMPLOYEES. IN MOST CASES OUR PLANS DO NOT REMOTELY RESEMBLE THE PLANS OFFERED BY OUR COUNTERPARTS IN THE PRIVATE SECTOR. IN A 1987 REPORT THE BUREAU OF LABOR STATISTICS FOUND THAT 94 PERCENT OF FULL-TIME EMPLOYEES IN STATE AND LOCAL GOVERNMENTS HAVE MEDICAL INSURANCE COVERAGE AND 85 PERCENT HAVE LIFE INSURANCE COVERAGE. THE REPORT FURTHER SHOWS THAT IN THE MAJORITY OF CASES, STATE AND LOCAL GOVERNMENTS PAY THE FULL COST FOR INDIVIDUAL COVERAGE. IN 27 PERCENT OF THE CASES, IT SHOWS THAT WE PAY THE FULL COST OF FAMILY COVERAGE AND IN AN ADDITIONAL 66 PERCENT OF THE CASES, WE PAY A PORTION OF THE COST FOR FAMILY COVERAGE. IN LIGHT OF THESE FACTS MR. CHAIRMAN, WE ARE CONVINCED THAT THE APPLICATION OF SECTION 89 TO STATE AND LOCAL GOVERNMENTS IS UNNECESSARY. IN FACT, IT WILL RESULT IN A DISSERVICE TO OUR EMPLOYEES AND INCREASED COSTS TO OUR TAXPAYERS.

COUNTIES ARE NOT MERELY PUBLIC EMPLOYERS, WE PROVIDE A FULL RANGE OF VITAL PUBLIC SERVICES TO OUR RESIDENTS INCLUDING HEALTH CARE, EDUCATION, LAW ENFORCEMENT, FIRE FIGHTING, COURTS, MAINTENANCE OF ROADS AND BRIDGES, AND NURSING HOMES. AS SERVICE PROVIDERS, WE MAINTAIN OVER 1000 HEALTH CARE FACILITIES ACROSS THE NATION, INCLUDING COUNTY HOSPITALS AND NURSING HOMES. WE SPEND A SIGNIFICANT AMOUNT OF OUR REVENUES EACH YEAR TO PROVIDE HEALTH CARE TO UNINSURED INDIGENTS. FOR MANY OF US, THIS IS ONE OF THE HIGHEST, IF NOT THE HIGHEST, ANNUAL COST FOR COUNTY SERVICES. THE 1986 BUREAU OF THE CENSUS REPORT SHOWS THAT

COUNTIES SPENT $14.9 BILLION ON HEALTH CARE SERVICES. IT ALSO IDENTIFIES $7.2 BILLION AS UNCOMPENSATED HEALTH CARE COSTS FOR HOSPITAL SERVICES. WHILE THESE COSTS REPRESENT THE TOTAL LOSS FOR PUBLIC AND PRIVATE HOSPITALS, IT IS SAFE TO ASSUME THAT THE VAST MAJORITY OF THESE COSTS WERE BORNE BY COUNTY HOSPITALS SINCE PRIVATE HOSPITALS USUALLY REFER UNINSURED PATIENTS TO OUR HOSPITALS.

ONE OF THE PRIMARY SAFEGUARDS AGAINST DISCRIMINATION IN THE PUBLIC SECTOR IS THE ELECTORAL PROCESS. EVERY TWO TO FOUR YEARS OUR VOTERS, INCLUDING OUR EMPLOYEES,HOLD US ACCOUNTABLE FOR THE DECISIONS WE MAKE WHICH AFFECT PUBLIC POLICY. IN FLORIDA, OUR VOTERS DON'T MIND LETTING US KNOW WHEN WE MAKE DECISIONS THEY DISAGREE WITH. ANOTHER SAFEGUARD AVAILABLE IN MANY AREAS IS THE COLLECTIVE BARGAINING PROCESS WHICH INVOLVES PUBLIC EMPLOYERS REACHING AGREEMENT WITH UNION REPRESENTATIVES OF THEIR EMPLOYEES ON PAY, BENEFITS AND WORKING CONDITIONS. BENEFITS UNDER UNION AGREEMENTS ARE MUTUALLY ACCEPTED BY BOTH THE EMPLOYER AND THEIR EMPLOYEES. THE LAST SAFEGUARD I WILL MENTION IS THE COUNTY'S RESPONSIBILITY TO CARE FOR UNINSURED INDIGENTS. IN 36 STATES WE ARE MANDATED BY LAW TO PROVIDE HEALTH CARE SERVICES TO UNINSURED INDIGENTS. COUNTIES SPEND BILLIONS OF DOLLARS EACH YEAR TO PROVIDE INDIGENTS NEEDED HEALTH CARE. WE ARE NOT IN A POSITION TO DODGE THE UNINSURED. BECAUSE HEALTH CARE COSTS CONTINUE TO CLIMB, NO ONE HAS A GREATER INTEREST IN SEEING HEALTH INSURANCE COVERAGE EXPANDED TO UNINSURED WORKERS THAN COUNTY OFFICIALS. HOWEVER, INSTEAD OF ENCOURAGING EXPANDED COVERAGE, WE BELIEVE SECTION 89 WILL CAUSE MANY EMPLOYERS TO DROP OR REDUCE BENEFITS.

IN SUMMARY, MR. CHAIRMAN, WE BELIEVE HR 1864 WOULD SIMPLIFY THE EXISTING SECTION 89 NONDISCRIMINATION RULES. WE BELIEVE THESE RULES SHOULD BE APPLIED TO AREAS WHERE BROAD-BASED DISCRIMINATION EXISTS. THEY SHOULD NOT BE APPLIED TO PUBLIC EMPLOYERS WHO HAVE TRADITIONALLY OFFERED THE SAME LEVEL OF BENEFITS TO ALL OF THEIR EMPLOYEES AND WHO HAVE SAFEGUARDS IN

PLACE TO PROTECT AGAINST DISCRIMINATION. TO DO SO, WHEN THERE IS NO EVIDENCE OF DISCRIMINATION, WOULD BE A DISSERVICE TO OUR EMPLOYEES AND INCREASE COSTS TO OUR TAXPAYERS. WE STRONGLY ENCOURAGE YOU AND ALL MEMBERS TO SUPPORT LEGISLATION THAT WILL EXEMPT STATE AND LOCAL GOVERNMENTS FROM SECTION 89.

MR. CHAIRMAN, I COMMEND YOU FOR HOLDING THIS HEARING TO EXAMINE THE IMPACT OF SECTION 89 AND THE VARIOUS VIEWS ON THE PROPOSED LEGISLATION. I APPRECIATE THE OPPORTUNITY TO TESTIFY AND I WOULD BE HAPPY TO ANSWER ANY QUESTIONS AT THE APPROPRIATE TIME.

Mr. Russo. Thank you very much, Mr. Wood.

Mr. Pickle.

Mr. Pickle. Mr. Chairman, thank you. First, Mr. Wood, I would say to you that it already has been testified that we have some 14½ million local and State employees. That is a lot of people. You want to exempt them because you say there is no discrimination being practiced in that ring.

Now that is the same position that all the others take, too. They all say that we do not need to be covered, they ought to be exempt. If you exempt 14½ million people, we are put in a position that we are going to assume it is not needed because you are giving that kind of coverage.

But we do not know what kind of coverage you are giving. This committee does not know what 14 million people across the country are receiving in the way of benefits, whether that is in Florida or in Texas or New York or Massachusetts. We just do not have that information. That is why we are trying to make it uniform.

Now you may have a good point. You and Mayor Cooke also suggested that what you might do is try to have a better definition of what is an employer. I think that is a legitimate question to raise. Do either of you have a suggestion of how we would change the definition?

Do any of you have a suggestion how you would change the definition of an employer so we might take a closer look at it?

Mr. Cooke. Congressman, one of the things that I said in my comments, what we feel as far as the definition of the employer should be the entity, the organization that actually has the budgetary authority over the benefits administration where we are actually setting the budgets. If that could be considered in the legislation, as far as the employer, that would be one thing that I would offer up.

Mr. Wood. Mr. Congressman, one of the things from our point of view is the Bureau of Labor Statistics found that 94 percent of the full-time employees of State and local government already have full-time medical coverage. We are saying that happens.

The other thing is when this body considered the ERISA legislation back in the 1970's they came to the conclusion, at that time, that local and State governments were already in that area and they were exempted, however they reserved the right if they found discriminatory practices through some type of an audit, to come in and find the employer responsible.

Mr. Pickle. I understand, as a general rule, that about 94 percent of them are covered now satisfactorily. In Mayor Cooke's case, he said we have 8,953 local employees. That is a lot of people. What does that cost your city, if you complied with this H.R. 1864 bill?

Mr. Cooke. If we just looked specifically at the testing and probably urban cities are going to probably have a lower cost than a lot of your smaller communities would, but we are probably talking including maintaining the health insurance as well as the testing, we're talking—from what I got from our personnel people today—in the $350,000 to $400,000 range.

That may not seem like a lot of money, and the total benefits that the city of Austin pays to those employees is close to $40 million a year. So I mean that is a tremendous amount of money going to our benefits program, but that is just an additional cost, and additional personnel we are going to have to add to our staff.

Mr. PICKLE. I suppose you would agree that essentially the city employees should have the same type of coverage or right of coverage as private employees. That is what we are trying to achieve in this particular bill, but we do recognize that it will cost money.

The last question I want to ask you, Mayor, is you said you were concerned about the premium amount that is the $10 and $25, the set sum. You suggest that the dollar limits be dropped on local and State government. Can you suggest any alternative or did you suggest, in your testimony, any alternative if we just dropped it? What else would we do?

Mr. COOKE. You might look, rather than just sort of coming up to the cliff and just stopping, you might look at some kind of a tiered effect or percentage arrangement as an alternative consideration. Right now, for instance, there is a number of States that would be out of compliance, including Texas.

As far as family coverage for benefits and dependents, we would be out of compliance under the testing right now. The city of Austin probably would be out of compliance with our budget that starts October 1. Not for the individual employee but for the employee that has dependents on health coverage.

Mr. PICKLE. I thank you, Mayor. I can see it is a problem for our State and local governments across the land, and yet we have to ask can we just exclude them separate and apart from all others? Or is their coverage that much different from private employees? That is the basic question we have to ask ourselves.

I appreciate your testimony and it is good to have you up here representing the city of Austin and the National League of Cities.

Mr. COOKE. Thank you.

Mr. RUSSO. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

I sympathize with you since, I am a product of local government. At the same time, we have heard panel after panel today come and talk to us about multiemployer plans that ought to be excluded because of the complexity in determining who the employer was and keeping track of the hours.

We have also had testimony from 501(c)(3)'s who perform notable services like workshops for the retarded who think that they are in a unique situation. There are many other problems.

We attempted, frankly, when we started this exercise to first of all get rid of the data collection problems, and I think the designed based nature of the test pretty well helps that along. We also tried to address the problems with part-time employees. We all recognize that 17.5 hours was not a reasonable number. Regarding leased employees, Mr. Calhoun, you addressed that in your testimony. We attempted to correct that problem also in H.R. 1864.

In terms of retired employees or former employees, we are attempting to be prospective in nature and hopefully only determine those in the test that were perhaps retirees, rather than former employees.

We have therefore tried to address and correct most, if not all, of the major concerns that have developed under current section 89.

I appreciate the fact that you have come in and given us the benefit of your testimony, and certainly it will be considered. Thank you.

Mr. Russo. Thank you very much. We appreciate you having to wait all day long to get your testimony, but we appreciate your being here. Thank you very much.

With that, that concludes the testimony on the famous section 89.

[Whereupon, at 4:02 p.m., the committee was adjourned.]

TO SIMPLIFY THE NONDISCRIMINATION RULES APPLICABLE TO EMPLOYEE BENEFIT PLANS UNDER SECTION 89 OF THE INTERNAL REVENUE CODE

WEDNESDAY, MAY 3, 1989

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. Good morning.

Today, this committee begins the second day of hearings on H.R. 1864, a bill to reform section 89 of the Internal Revenue Code. Yesterday we took testimony from the administration and representatives of a wide range of groups, including employers, the AFL–CIO, and State and local governments.

Today we continue that process. I want to repeat what I said yesterday about this bill. I think it is a good bill. I am not interested in hearing how it might be made less effective, but whether it has hidden complexities that this committee might address.

I would like at this time to welcome my colleague, both on the committee and from the State of Illinois, a great representative from the northwest side of the suburbs of Chicago, Phil Crane.

Phil, we are ready to take your testimony.

STATEMENT OF HON. PHILIP M. CRANE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. Crane. Thank you, Mr. Chairman.

First of all let me congratulate you for opening up a dialog on what was a well-intentioned insertion into the tax law, but which has some complications that you have already heard testimony on.

In my district, I have the corporate headquarters of Motorola. They are probably the leading employer in my district, and they have 67,000 employees in the United States, and their estimate of the startup costs of implementation of section 89 is an average of $1 to $3 per employee per month for the first year. The out-year costs are expected to average $3 per year per employee, and their argument, of course, is that this is money wasted and an attempt just to test. This does not include penalties or additional taxes.

Zurich American Insurance is another employee in my area, and their cost to test alone, they estimate will exceed $27,500 this year with a tax revenue loss to the Government of $9,300.

I mention this only to give an indication of the importance of getting input, I think, from the corporate community as they work to adjust to this alteration of the law.

On January 19 of this year, I introduced a bill, H.R. 518 which would delay section 89 until January 1, 1990. We had 132 cosponsors on that, and Senator Symms introduced a companion measure, S. 89, and he has 35 cosponsors on that.

We also sent a letter to Treasury asking for some unspecified relief for employers due to the impending action that our committee is going to take, and they responded, of course, by delaying the July 1, 1989, compliance State until October 1 of this year, which I think is a reason for complimenting the Treasury on swift action.

A key portion of any section 89 reform, I think, has to be delayed. We must give Treasury a chance to release regulations and then give businesses a chance to understand and comply with 1989 reform. This also will give Members a chance to correct any gross problems of the regulations.

In the area of reform, there are five major provisions in the bill that I introduced, and H.R. 1682, which I introduced on the heals of my first one after the first IRS regs came out is a compilation of corrections to section 89, brought forth primarily by representatives from the business community.

Let me quickly review these, and ask for unanimous consent that my statement be inserted in the record.

Chairman ROSTENKOWSKI. Without objection, so ordered.

Mr. CRANE. Thank you, Mr. Chairman.

First of all, elimination of all tests except the 80-percent test, which under my bill would be reduced to a 70-percent test. The 70-percent test has been included to meet the need for a simpler test that would allow for broader compliance. This eliminates the need to run many costly and time consuming tests to determine compliance.

Second, exclusion from the test of employees who normally work less than 35 hours per week. One of the biggest problems with the section 89 regulations is the perception that a part-time employee is always entitled to the same benefits as the full-time employee.

The added cost of including part-time employees will dictate the elimination of many part-time and temporary jobs. The elimination of those jobs can only reduce payroll taxes, increase costs to Government need programs, and increase unemployment.

Third, exclusion from the test of least employees, union employees covered by a collective-bargaining agreement, mandatory retirees, and enrollees covered under the older American Community Service Employment Act.

Once again, as in the situation involving part-time employees, the use of least employees and enrollees will precipitate the elimination of these types of employment opportunities. Union employees covered by collective-bargaining agreements already have benefits plans that they have agreed to in principle.

So, their inclusion in section 89 will unnecessarily increase the cost of the business. Mandatory retirees who are by law required to terminate employment will also be exempted from the test.

Fourth, the penalties associated with the violation of section 89 would not exceed the cost of such benefit to the employer. This provision would squarely place the blame for the violation where it belongs, on the employer. Most representatives of the business community have supported this provision.

The penalties would also not exceed the cost to the employer providing the benefit. It was a gross mistake to include in the taxable income the received benefit that is provided to the employee. We have all heard the potential horror stories about an individual who received heart surgery at a cost of $100,000, and how this forces his income for the year into a drastically higher tax bracket. This provision would place the costs where they belong in the hands of the business itself.

And finally, Mr. Chairman, the most important signal we can send to the many affected by section 89 is the desire for this committee to understand our abilities and perhaps limitations, and to reaffirm our desire to work with them for a more palatable means of regulating nondiscriminatory benefits regulations.

By incorporating a delay of the enforcement of section 89 until January 1, 1990, we say to the business community that we understand that we have been making much needed corrections to some of the worst provisions of section 89, and while we continue to pursue more workable provisions, we believe it is in the best interest of everyone to push compliance into the future.

Any major changes to section 89 require delay to allow the Department of the Treasury to produce needed regulations in a timely manner, allow businesses to make needed adjustments, and allow the Members of this body to understand what they have enacted.

And, again, Mr. Chairman, I want to salute you because I know it is not easy to go back and reexamine things that we have incorporated in previous legislation, but I think that the current section 89 provision while following in part the intent of what we had hoped we were accomplishing, unfortunately does not meet the test, and as a result, I salute you for reopening this issue for reconsideration for review to modify and streamline, making the provision easier for businesses to comply with while meeting the overall objectives of the committee.

[The statement of Congressman Philip M. Crane follows:]

TESTIMONY OF
CONGRESSMAN PHILIP M. CRANE
PRESENTED TO THE MEMBERS OF
HOUSE WAYS AND MEANS COMMITTEE

MAY 2, 1989

Mr. Chairman, it is with great relief that I sit before this committee to testify on what many have deemed the biggest "tax" issue for this esteemed group of Members this year. Section 89 of the Internal Revenue Code has taken us all on an emotional roller-coaster ride in our attempts to better understand its provisions and directives. The results of our 1986 efforts to bring unneeded discrimination rules to employee health plans has resulted in an embarrassment to this committee and an outcry from the backbone of this country -- the business community.

As we are all well aware, Section 89 was included in Tax Reform Act of 1986 as an attempt to impose nondiscrimination and qualification rules with respect to certain employer-provided benefits. These provisions were modified in the Technical and Miscellaneous Revenue Act of 1988. In 1989, just three years after the implementation of Section 89, a mere 122 days after these misguided provisions were enacted, and 62 days after the release of the Internal Revenue Service Notice of Proposed Rulemaking, we are now considering a massive overhaul of nondiscrimination rules.

The problems with section 89 are numerous and complex. Exemplifying just one example of the problems faced by employers with the enactment of Section 89, is the limited resources of small businesses and associations. The Internal Revenue Service estimates it will take up to forty-four hours per year for an employer to learn the provisos of Section 89, qualify his plans and apply them as a test for discriminatory practices. Most small businesses and associations will be forced to hire additional consultants to endure this task for them simply because they do not have the technical resources necessary to complete such an immense endeavor. Time and expense dictated by this process will be detrimental and will ultimately lower the taxable income of the employer for the year. A lower tax base will result in lost revenues and, with the critical status of our nation's budget deficit, a rule that was purportedly designed to raise revenues will ultimately constitute a revenue loser.

It is these problems and complications that have led to near revolt of the business community and prompted the great concern of the Members of this great body. I have personally taken great interest in the intricate maze of Section 89 and have worked vigorously to air the justified complaints of the business community. On January 19th of this year, I introduced the first of two bills designed to breach the problems of Section 89. The first of these bills, H.R. 518, was the first Section 89 bill introduced in the 101st Congress. It was a simple bill that requested a delay of the effective date of Section 89 until January 1, 1990, providing some relief to businesses. Senator Steven Symms of Idaho introduced the Senate counterpart. H.R. 518 garnered over 130 bipartisan cosponsors, including 10 of my colleagues on the minority side of Ways and Means.

On January 24, 1989, Congressman John LaFalce introduced a bill that garnered close to 300 cosponsors. The bill, H.R. 634 would repeal Section 89. The business community, led by the National Federation of Independent Business and the U.S. Chamber of Commerce, mobilized to bring this bill the substantial support it has mustered. Senator Trent Lott introduced the Senate companion bill. After much thought and input from the many firms affected by our attempt to add nondiscrimination rules to the tax code, a series of Section 89 reform bills were introduced including two in the Senate - S. 595 introduced by Senator Pete Domenici, and S. 654 introduced by Senator David Pryor - and two in the House. The pretext of today's hearing is to discuss H.R. 1864, the Chairman's bill, and the other House reform bill of my own design, H.R. 1682, a bill that was introduced April 5. The one common issue touted by all these reform bills is the need to view them as discussion-oriented legislation. I heartily commend you Mr. Chairman, for understanding the need to discuss the issue in an open forum such as today's hearing.

The ideas I wish to address today are included in H.R. 1682, a bill I introduced to provide an open discussion regarding the options for transforming Section 89 into a manageable directive that will receive the support of the business community. H.R. 1682 is a compilation of corrections to Section 89 borne of ideas set forth by numerous representatives of all aspects of the business community. There are five major sections of H.R. 1682;

1) Elimination of all tests except the 80% test which would be reduced to a 70% test. The 70% test has been included to meet the need for a simplier test that would allow for broader compliance. This eliminates the need to run many costly and time-consuming tests to determine compliance.

2) Exclusion from the test of employees who normally work less than thirty-five hours per week. One of the biggest problems with the Section 89 regulations is the perception that a part-time employee is always entitled to the same benefits as a full-time employee. The added cost of including part-time employees will dictate the elimination of many part-time and temporary jobs. The elimination of those jobs can only reduce payroll taxes, increase costs to government need programs, and increase unemployment.

3) Exclusion from the test of leased employees, union employees covered by a collective bargaining agreements, mandatory retirees, and enrollees covered under the Older American Community Service Employment Act. Once again, as in the situation involving part-time employees, the use of leased employees and enrollees will precipitate the elimination of these types of employment opportunities. Union employees covered by collective bargaining agreements already have benefit plans that they have agreed to in principle, so their inclusion in Section 89 will unnecessarily increase the cost to the business. Mandatory retirees who are by law required to terminate employment will also be exempted from the test.

4) The penalties associated with a violation of Section 89 would not exceed the cost of such benefit to the employer. This provision would squarely place the blame for the violation where it belongs - on the employer. Most representatives of the business community have supported this provision. The penalties would also not exceed the cost to the employer of providing the benefit. It was a gross mistake to include in the taxable income the received benefit that is provided to the employee. We all have heard the potential horror stories about an individual who receives heart surgery at a cost of $100,000 and how this forces his income for the year into a drastically higher tax bracket. This provision would place the costs where they belong: in the hands of the business itself.

5) The most important signal we can send to the many affected by Section 89 is the desire for this committee to understand our abilities and to reaffirm our desire to work with them for a more palatable means of regulating nondiscriminatory benefit regulations. By incorporating a delay of the enforcement of Section 89 until January 1, 1990, we say to the business community, "we understand that we have been making much needed corrections to the egregious provisions of Section 89 and, while we continue to pursue more workable provisions, we believe it is in the best interest of everyone to push compliance into the future." Any major changes to Section 89 require a delay to allow the Department of the Treasury to produce needed regulations in a timely manner, allow businesses to make needed adjustments, and allow the members of this body to understand what they have enacted.

Mr. Chairman, I have presented to this committee a position that is designed to heighten the discussion of reform for Section 89. It is imperative that we move to a position that will allow the business community to comply without undue hardship, expense and paperwork. I have stated the need for a delay as an affirmation to those affected by Section 89 that we hear their concerns and want to help. It is vital that we do not let this moment escape us by failing to make a serious attempt to reform Section 89. Mr. Chairman, once again I commend you for your timely call for these most important hearings. From the number of organizations, associations and individuals who have requested to address this body, the importance of the issue is obvious.

Chairman **Rostenkowski**. Thank you very much.

Are there any questions of my colleague?

Mr. **Brown**. Thank you, Mr. Chairman.

Mr. Crane, I just want to commend you for your leadership in this area. It is very clear that compliance with the provisions of section 89 as they were originally written involve an enormous paperwork burden, and your sensitivity to that and your willingness to lead the efforts to simplification are greatly appreciated.

Mr. **Crane**. Thank you very much.

Chairman **Rostenkowski**. Thank you.

Mr. **Crane**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Nolan, Mr. Epstein, Mr. McKeever, Mr. Sandler.

[Pause.]

Chairman **Rostenkowski**. Welcome to the committee. I believe you all are aware of our format. If your statement is longer than 5 minutes, we would like for you to summarize it. However, your entire statement will be included in the record. We are looking forward to your testimony.

If you would like to begin, Mr. Nolan.

STATEMENT OF WALKER F. NOLAN, SENIOR VICE PRESIDENT, EDISON ELECTRIC INSTITUTE, ACCOMPANIED BY HENRY ULLMAN AND MURRAY GOULD, TAX MANAGER, CAROLINA POWER & LIGHT CO.

Mr. **Nolan**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. I would like for you to identify yourself for the record, as well.

Mr. **Nolan**. Mr. Chairman, I am Walker Nolan, senior vice president of the Edison Electric Institute, and I appreciate the opportunity to appear before you today representing EEI, and to present our views on H.R. 1864. I am accompanied today, also, by Mr. Murray Gould, our tax manager of Carolina Power & Light Co.; he is vice chairman of the EEI Taxation Committee. And Henry Ullman, who is the chairman of the EEI Compensation Benefits Committee.

EEI is the association of electric companies. Its members serve 97 percent of all customers served by the investor-owned segment of the industry. EEI members generate approximately 77 percent of all electricity in the country, and provide electric service to 73 percent of the Nation's ultimate electricity customers.

Mr. Chairman, we believe H.R. 1864 is superior legislation that will significantly reduce the severe administrative burdens of complying with current law and will result in much fairer treatment of employees.

Most electric utilities have a health care program that is available on a very broad basis, generally to all of their employees—executives, middle management, and rank and file. Obviously under such arrangements, there is no discrimination among classes of employees. Because H.R. 1864 has a testing procedure that looks to availability for health care benefits and not to the benefits elected or received by employees, its results will be both fair and appropriate.

Mr. Chairman, even excellent pieces of remedial legislation often contain some provisions that are impractical or that will not be wholly appropriate in application. Thus, while we strongly support the overall objectives and general intent of H.R. 1864, we do have several concerns with the bill and would like to offer some suggestions to remedy them.

First, under the leased employee rules, the most significant concern of EEI relates to the treatment of leased employees under H.R. 1864. The bill provides a safe harbor with respect to certain leased employees. Although that provision properly places the determination of whether a leased employee is eligible for a qualified core health plan at the leasing organization level the provision also needs to provide a reasonable period of transition in order to be workable. By providing transition rules, the bill will allow an adequate period of time to modify existing contractual arrangements and to implement the intended qualified core health plan contribution limits provided in the bill.

In addition to the recommended transition period, we also believe that the safe harbor for certain leased employees should be modified to allow the exclusion of any leased employee if the leasing organization makes available to its employees affordable core health care benefits. That is, the 20-percent restriction should be deleted.

A second concern is salary reduction. The benefits test is designed to insure that highly compensated employees do not receive a disproportionately higher level of employer-provided benefits than are made available to rank-and-file employees. For purposes of this test, salary reductions under a cafeteria plan made by highly compensated individuals are to be treated as employee contributions.

We recommend that the proposed benefits test be modified so that salary reductions are treated as employee contributions for both highly compensated and nonhighly compensated employees and that employers be allowed to continue to choose to test dependent care assistance programs under either section 89 or section 129 as allowed by current law. The requirement to treat salary reduction amounts as employer-provided benefits only for highly compensated employees is simply inequitable and distorts the amount of actual employer-provided benefit. In addition, because the group of employees that are considered highly compensated can include many employees covered under a collective-bargaining agreement, this limitation can hurt the rank-and-file employees that it was expressly designed to help. In fact, in many instances, a cafeteria plan was adopted as a product of collective bargaining. We believe equal treatment of all employees for purposes of this test is appropriate.

Third, collectively bargained employees versus the entire work force. As you proposed in H.R. 1864, Mr. Chairman, the provisions of section 89 are to be applied separately to employees included in a qualified bargaining unit. That rule is to be applied in all situations, even where the same core health-care plan is available both to union and to nonunion employees.

One of the principal attributes of H.R. 1864 is the simplification that it brings to a highly complicated operation. However, requiring that an employer with union employees must maintain two distinct procedures for the operation of section 89 results in more complexity rather than simplicity.

Both collectively bargained employees and employers would be better served if this provision were made elective.

And last, indexing of mandatory employee contributions. H.R. 1864 properly recognizes the need to index the maximum employee contribution limit of $10 per week for employee-only coverage and $25 per week for family coverage for a qualified core health care plan. While indexing is designed to recognize adjustments in these maximum contributions, the use of the average wage index proposed in H.R. 1864 may result in distorted adjustments.

We realize the average wage index was chosen because of the importance of maintaining affordable employee premiums. However, health care premiums, whether borne by employers or employees, are most closely linked to changes in health care costs, the use of a medical care index would be more appropriate. Unless the permissible employee-paid component is indexed in this manner, the ability of employers to share the costs of these benefits with employees may gradually erode to a point where it is insignificant, a result inconsistent with basic overall health care cost principles.

Mr. Chairman, this concludes my prepared statement, and I would be pleased to have the opportunity to answer questions.

[The statement of Walker F. Nolan follows:]

STATEMENT OF WALKER F. NOLAN, SENIOR VICE PRESIDENT, EDISON ELECTRIC INSTITUTE

Mr. Chairman and members of the Committee, I am Walker F. Nolan, Senior Vice President of the Edison Electric Institute (EEI). I appreciate the opportunity to appear before you today representing EEI to present our views on H.R. 1864.

EEI is the association of electric companies. Its members serve 97 percent of all customers served by the investor-owned segment of the industry. EEI members generate approximately 77 percent of all electricity in the country and provide electric service to 73 percent of the nation's ultimate electricity customers.

Mr. Chairman, we believe H.R. 1864 is superior legislation that will significantly reduce the severe administrative burdens of complying with current law and will result in much fairer treatment of employees.

Most electric utilities have a health-care program that is available on a very broad basis, generally to all of their employees -- executives, middle management, and rank-and-file. Obviously, under such arrangements, there is no discrimination among classes of employees. Because H.R. 1864 has a testing procedure that looks to availability for health-care benefits and not to the benefits elected or received by employees, its results will be both fair and appropriate.

Almost as important to electric utilities is the simplified approach of H.R. 1864 compared to current law. The time and cost that employers would have to devote to compliance with the complex provisions of current law would be dramatic, and the exceptions and safe harbors that have been added since the enactment of section 89 have made even more complex the procedures that would be necessary for its implementation. For example, under H.R. 1864, employers will not have to monitor employees' health care coverage on a continuous basis, and there is not a need to determine the family status of employees and whether they have alternative coverage. Instead, by designing a health care program that is available to broad segments of employees, the program will not be discriminatory. Thus, it can be expected that the cost of administering H.R. 1864 will be only a small fraction of the expected high cost of complying with current law.

H.R. 1864 very admirably will accomplish two important goals: It will not penalize plans where the same health care coverage is available to broad classes of employees, and it will significantly ease the burdens and the cost of compliance. Mr. Chairman, EEI thanks you for addressing and rectifying problems that all businesses and their employees would have faced.

Mr. Chairman, even excellent pieces of remedial legislation often contain some provisions that are impractical or that will not be wholly appropriate in application. Thus, while we strongly support the overall objectives and general intent of H.R. 1864, we do have several concerns with the bill and would like to offer some suggestions to remedy them.

Leased Employee Rules

The most significant concern of EEI relates to the treatment of leased employees under H.R. 1864. The bill provides a safe harbor with respect to certain leased employees. Although that provision properly places the determination of whether a leased employee is eligible for a qualified core health plan at the leasing organization level, the provision also needs to provide a reasonable period of transition in order to be workable. By providing transition rules, the bill will allow an adequate period of time to modify existing contractual arrangements and to implement the intended qualified core health plan contribution limits provided in the bill.

The elements of such a transition period would include, in our view, the following:

(1) An overall moratorium on the application of the leased employee rules to section 89 for the year 1989.

(2) The application of the leased employee rules to section 89 for the year 1990 based upon the availability of a core health plan, whether or not such plan meets the qualification rules limiting employee contributions to $10 per week for individuals and $25 per week for family coverage. Beginning in 1991, the provisions presently contained in H.R. 1864 would become effective.

In addition to the recommended transition period, we also believe that the safe harbor for certain leased employees should be modified to allow the exclusion of any leased employee if the leasing organization makes available to its employees affordable core health care benefits. That is, the 20 percent restriction should be deleted.

The requirement that recipient organizations include leased employees in the section 89 testing even though the leasing organization provides affordable benefits is administratively burdensome and unnecessary.

Salary Reduction

Under H.R. 1864, the benefits test is designed to ensure that highly-compensated employees do not receive a disproportionately higher level of employer-provided benefits than are made available to rank-and-file employees. For purposes of this test, salary reductions under a cafeteria plan made by highly-compensated individuals are to be treated as employer contributions.

We recommend that the proposed benefits test be modified so that salary reductions are treated as employee contributions for both highly compensated and non-highly compensated employees and that employers be allowed to continue to choose to test dependent care assistance programs under either section 89 or section 129 as allowed by current law. The requirement to treat salary reduction amounts as employer-provided benefits only for highly- compensated employees is simply inequitable and distorts the amount of the actual employer-provided benefit. In addition, because the group of employees that are considered highly-compensated can include many employees covered under a collective bargaining agreement, this limitation can hurt the rank-and-file employees that it expressly was designed to help. In fact, in many instances, a cafeteria plan was adopted as a product of collective bargaining. We believe equal treatment of all employees for purposes of this test is appropriate.

Collectively-Bargained Employees vs. Entire Workforce

As you have proposed in H.R. 1864, Mr. Chairman, the provisions of section 89 are to be applied separately to employees included in a qualified bargaining unit. That rule is to be applied in all situations, even where the same core health-care plan is available both to union and to nonunion employees.

One of the principal attributes of H.R. 1864 is the simplification that it brings to a highly complicated operation. However, requiring that an employer with union employees must maintain two distinct procedures for the operation of section 89 results in more complexity rather than simplicity.

Both collectively-bargained employees and employers would be better served if this provision were made elective. That is, employers should be given the option to apply section 89 either separately with respect to employees included in a qualified bargaining unit or to the employer's entire workforce.

Indexing of Mandatory Employee Contributions

H.R. 1864 properly recognizes the need to index the maximum employee contribution limit of $10.00 per week for employee-only coverage and $25.00 per week for family coverage for a qualified core health care plan. While indexing is designed to recognize adjustments in these maximum contributions, the use of the average wage index proposed in H.R. 1864 may result in distorted adjustments.

We realize the average wage index was chosen because of the importance of maintaining affordable employee premiums. However, health care premiums, whether borne by employers or employees, are most closely linked to changes in health care costs, the use of a medical care index would be more appropriate. Unless the permissible employee-paid component is indexed in this manner, the ability of employers to share the costs of these benefits with employees may gradually erode to a point where it is insignificant, a result inconsistent with basic overall health care cost principles.

Mr. Chairman, this concludes my prepared statement. We are pleased to have the opportunity to testify on this needed legislation. I would be pleased to answer any questions you or Members of the Committee may have.

Chairman ROSTENKOWSKI. Thank you very much, Mr. Nolan. Mr. Epstein.

STATEMENT OF ALLEN EPSTEIN, CHAIRMAN, TAX COMMITTEE, NATIONAL CONSTRUCTORS ASSOCIATION, AND DIRECTOR, CORPORATE TAX, EBASCO SERVICES, INC., NEW YORK, NY

Mr. EPSTEIN. Thank you, Mr. Chairman, members of the committee.

I am Allen Epstein, director, corporate tax, Ebasco Services, Inc., New York. I am here today representing the National Constructors Association. The NCA greatly appreciates the opportunity to present our views on section 89 today.

We represent this Nation's largest firms engaged in the design and construction of major commercial, industrial and process facilities worldwide. We have submitted a statement for the record. I would like to summarize that here.

At the outset, we would like to applaud the committee for its willingness to consider simplification of section 89, and we believe that Chairman Rostenkowski's bill goes a long way toward that goal.

However, we are concerned that H.R. 1864 does not yet adequately address the section 89 problems with our particular industry in two specific areas. One, the requirement the employers test multiemployer plans and be penalized for failure to meet these requirements. Two, the exclusion from the nondiscrimination rules of employees who work less than 25 hours per week.

In the construction industry, employers seek workers through union hiring polls. These workers typically work for many different contractors during the year, often for short periods, and they work for the same contractor several times in the same year.

Each employer keeps pay records only for the periods of employment with that contractor, and pursuant to good faith, collective-bargaining agreements, these workers may receive medical insurance, life insurance and other benefits through a multiinsurer plan.

Multiemployer plans are those where two or more employers contribute to a pooled fund on behalf of that part of their work force covered by a particular contract. Only the amounts of the employer's contribution is specified to good faith collective bargaining. The employers and the unions do not negotiate the type or amounts of benefits that will be provided.

Individual contributing employers exercise no control over multiemployer plan benefit design, level of contributions, or health or other benefits and the different options within the plan. Trustees of the plan make these decisions. The trustees are appointed by labor and management, but they operate independently of the employers who make the contributions.

However, not withstanding the curative effect of Chairman Rostenkowski's simplification amendments, the rules of section 89 do not work well when applied to multiemployer benefit plans. H.R. 1864, by adding new section 4980(c) to the Internal Revenue Code, would impose an excise tax on the employer equal to 34 percent of the amount of the benefits paid on the health and other specified employee benefit plans that do not meet a number of qualification requirements relating to the form of the plan, the documents, the notification to employees, enforceability, et cetera.

Generally, the multiemployer plan trustees who control and administer the benefits are in a position to see that these requirements are satisfied. It is quite unfair to impose a penalty, particularly so severe a penalty upon employers for matters that are outside of their own control.

Under current law, employees are taxed if a plan fails the qualification requirements. This lack of control by employees over such planned design and administration is H.R. 1864's stated rationale for shifting the applicable tax penalty from employees to employers. This same rationale supports the exclusion of multiemployer plan sponsors from such penalties.

Like many other industries, we are concerned about the nondiscrimination rules and we concur in their desire to relax the eligibility and benefit thresholds. However, rather than reiterating much of which has been discussed in this regard, we would like to focus your attention on one particular detail that is of specific concern to our industry: the exclusion of employees who normally work less than 25 hours per week from the benefits test. It is not clear whether this definition of part-time employees includes employees who work an average of less than 25 hours per week or only those who work less than 25 hours per week on a regular basis.

We encourage you to expand the definition to include employees who work less than an average of 25 hours, and we thank you for allowing us to discuss this situation.

Thank you, sir.

[The statement of Allen Epstein follows:]

By the
National Constructors Association

Statement for the Record
Committee on Ways and Means
United States House of Representatives

May 3, 1989

The National Constructors Association (NCA) appreciates the opportunity to address the Ways and Means Committee regarding a subject of great concern to its membership, Section 89. The NCA is made up of many of the nation's largest firms engaged in the design and construction of major commercial, industrial and process facilities worldwide. We initially would like to applaud the Committee for its outstanding effort to simplify Section 89 by means of H.R. 1864. However, we believe that H.R. 1864 does not adequately address our concerns in two important areas: the treatment of multiemployer plans and the nondiscrimination tests.

MULTIEMPLOYER BENEFIT PLANS

1. What Are Multiemployer Plans?

Multiemployer benefit plans differ from single-employer benefit plans in the way that they are funded and administered. Under a multiemployer plan, two or more employers contribute to a pooled fund on behalf of that part of their workforce covered by a particular contract agreed to through the collective bargaining process in good faith. The benefits purchased from the fund are selected and administered, not by the employers, but by independent trustees.

Multiemployer plans are common in certain labor-intensive industries, such as the construction industry. The practice in the construction industry is for employers to request workers through union hiring halls. These workers typically work for many different contractors during the year, often for short periods, and may work for the same contractor several times in the same year. Each contractor keeps pay records only for the periods of employment with that contractor. Pursuant to good faith collective bargaining agreements, these employees may receive medical insurance, life insurance, and other benefits through a multiemployer plan.

Under a multiemployer plan, each employer is obligated by a good faith collective bargaining agreement to contribute a fixed dollar-and-cents amount per hour worked. The employers' contributions are pooled and used by the multiemployer plan trustees to purchase medical insurance and other benefits for the covered employees. Typically, employees are not required to contribute to multiemployer plans. Ordinarily, the contractors and unions do not negotiate the type or amounts of benefits that will be provided. Individual contributing employers exercise no control over multiemployer plan benefit design, such as the division of funds between health and other benefits and the different options within each benefit plan. The trustees are appointed by labor and by management, but they operate independently of the employers that contribute to the plan. Multiemployer plans are subject to the Taft-Hartley Act and to regulation by the Department of Labor.

2. The Qualification Test under H.R. 1864

Without doubt, H.R. 1864 constitutes a significant step forward in simplifying Section 89 in a manner that will enable employers to comply with its prescriptions. The shift in emphasis from plan participation to plan design is particularly noteworthy in that it greatly reduces time consuming and burdensome information gathering otherwise required of the employer.

However, notwithstanding the curative effect of Chairman Rostenkowski's simplification amendments, the rules of Section 89 do not work well when applied to multiemployer benefit plans. H.R. 1864 (by adding new section 4980C to the Internal Revenue Code) would impose an excise tax on the employer equal to 34 percent of the amount of the benefits paid under health and other specified employee benefit plans that did not meet a number of "qualification" requirements relating to the form of plan documents, notification to employees, enforceability of benefits, indefinite maintenance, etc. Generally, the multiemployer plan trustees, who control and administer the benefits, are in a position to see that these requirements are satisfied. It is quite unfair to impose a penalty, particularly so severe a penalty, upon employers for matters that are outside of their control. Under current law, employees are taxed if a plan fails the qualification requirements. Lack of control by employees over plan design and administration is H.R. 1864's stated rationale for shifting the applicable tax penalty from employees to employers. This rationale supports the exclusion of multiemployer plan sponsors from such penalties.

Even under the simplified rules of H.R. 1864, a substantial amount of information may have to be collected in order to avoid tax penalties. To prove that its plans satisfy the nondiscrimination requirements, an employer would have to determine which employees are highly compensated. The employer may also have to determine the type of health benefits (core coverage, family coverage, etc.) received by each employee, and the value of each type of health coverage.

Multiemployer plans, particularly in the construction industry, cover employees who may work for many different employers during a single year. Neither the plan trustees nor any one of the employers know an employee's total compensation for the entire year. Presumably, determination of whether an employee is highly compensated is based only upon the wages paid by the particular employer. See I.R.C. 414(q). If this interpretation should not be correct, and an employee's compensation from all of his different employers must be considered, neither the employer nor the trustees could comply with the statute.

Employers also do not know how much of their contribution to a multiemployer plan will apply to health benefits, what type of health benefits will be purchased, or the value of the benefits. Although H.R. 1864 (like current law) allows an employer to treat the actual contribution as the "employer-provided benefit", there are troublesome exceptions that could allow this rule to be undermined. Moreover, the employer would still have to calculate the allocation of the contribution among different benefits, which requires information that the employer does not possess.

H.R. 1864 provides that collectively bargained plans are tested separately, a major improvement over current-law Section 89. Since virtually all multiemployer plans will satisfy the nondiscrimination requirements when tested on a separate basis, forcing employers to collect the necessary data to perform the statutory tests is pointless.

3. The Nondiscrimination Tests under H.R. 1864

H.R. 1864's replacement tests for the nondiscrimination rules of Section 89 constitute a commendable step in the direction of simplification. However, we still have several concerns about the replacement tests.

Under H.R. 1864, employees who normally work less than 25 hours per week are excluded from consideration. It is not clear whether this rule excludes all employees who work an average of less than 25 hours per week or only those who work less than 25 hours. "Casual" employees may work more than 25 hours per week during some weeks but few or no hours during other weeks. Unless part-time employees are excluded on the basis of average hours worked, the 25 hour rule does not adequately address the problem of casual employees.

H.R. 1864 retains current law's 90 percent eligibility test. In reality, this is not a nondiscrimination requirement. Nondiscrimination should not mean that a specified percentage of employees must be eligible, but only that the percentage of highly compensated employees who are eligible must not be substantially greater than the percentage of rank-and-file employees who are eligible. As applied to a qualified savings plan, for example, the pension plan rules presently require only that the percentage of rank-and-file employees who are eligible be at least 70 percent of the percentage of highly compensated employees who are eligible. A savings plan for which 70 percent of rank-and-file employees were eligible would automatically qualify. Moving the Section 89 rules towards the qualified plan model would provide adequately for nondiscrimination without, in effect, mandating universal coverage.

The 133 percent benefits test of H.R. 1864 is substantially stricter than the 75 percent benefits test of current-law Section 89. The 133 percent rule would tax a highly compensated employee who participated in a health plan that was more than 33 percent better than any other health plan offered by the employer even if a proportionate number of rank-and-file employees also participated in the better plan. If the goal of this rule is to prevent discrimination by taxing highly compensated employees who receive substantially more benefits than rank-and-file employees, a more accurate and less arbitrary way of identifying "excessive" benefits should be found.

Finally, qualified core health plans may not require employee contributions in excess of $10 per week for individuals and $25 per week for family coverage, adjusted annually for inflation. This inflation adjustment is inadequate. Health care costs have been rising much faster than other components of inflation.

4. Recommendations

Multiemployer benefit plans collectively bargained in good faith should be excluded from the nondiscrimination rules of Section 89 and qualification rules of proposed Section 4980C. This would further Chairman Rostenkowski's goal of not sanctioning those who have no control over the failure to satisfy the nondiscrimination rules.

The definition of part-time employees should be clarified to include any employee who works an average of 25 hours or less per week during the testing year.

The 90 percent eligibility requirement should be reduced to 70 percent and/or the eligibility requirement should be satisfied by any employer that provides core health coverage to comparable percentages of highly compensated and rank-and-file employees.

The 133 percent limit should be eliminated or applied on the basis of the average benefits received by highly compensated and rank-and-file employees, as under current law.

The ceiling on employee contributions to qualified core health plans should be tied to an index that realistically represents increases in the cost of health coverage. We advocate the medical component of the Consumer Price Index as a good choice in this case. In addition, we recommend that the law make clear that contributions to pay for coverage that must be offered to comply with the health care continuation coverage requirements of COBRA should be disregarded for this purpose.

The NCA appreciates this opportunity to address the Committee regarding its concerns about Section 89 and H.R. 1864.

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Chairman ROSTENKOWSKI. Thank you, Mr. Epstein.
Ms. McKeever.

STATEMENT OF BONNIE McKEEVER, MANAGING DIRECTOR, EMPLOYEE BENEFITS, FEDERAL EXPRESS CORP.

Ms. MCKEEVER. Mr. Chairman and members of the committee, my name is Bonnie McKeever. I am the managing director of employee benefits for Federal Express Corp. I would like to thank you for this opportunity to testify in support of simplification of section 89. We have worked through our membership in the Washington Business Group on Health with the Section 89 Coalition, and appreciate their role in suggesting modifications to the law.

Federal Express was founded in 1973 as an express air cargo service. Since that time, the company has expanded to offer one of the finest overnight document package delivery service available. We currently handle over 1 million packages daily through our system. We now employ over 60,000 people across the country and our service is available to 99 percent of the population in the United States. Federal Express provides a very comprehensive package of medical, dental, and vision benefits equally to all employees. Part-time employees receive the same coverage as full-time employees as they have for over 15 years.

Our growth and prosperity are marked by the insight of our founder, Fred Smith, who recognized both the need for such a service and the benefit of our corporate philosophy—people-service-profit. The philosophy has as its cornerstone the people of the organization. The people-service-profit philosophy essentially means that in taking care of our people, they in turn will deliver the impeccable service demanded by our customers who will reward us with the profitability necessary to secure our future.

This philosophy is the very foundation of our success. It has led to the creation of progressive programs such as our survey feedback action program, which is an annual survey to measure our employees opinions concerning management leadership, satisfaction with pay and benefits, management fairness, whether we are doing a good job for our customers and a host of other items. As the number of employees has grown from 30,000 to 60,000, it has been harder and harder to improve some of the measurement indices we derive from the survey. Historically, these measurement indices have only varied by 1 percentage point per year. In short, it is difficult to satisfy 60,000 people at one time. This year, however, the results of the survey have shown an increase of 5 full percentage points. This the largest increase in the 10-year history of the program. Employee satisfaction is very high, and our progressive programs have also received positive attention from outside the company. We cannot rest assured that the status quo is satisfactory. However, we can assume that we are responding properly to the expressed needs of our employees. This is one reason that we oppose Government mandated benefits. We believe that through such mandates our flexibility to offer innovative benefit programs to meet our employees needs become limited. But that is not the subject at hand today. Let it be sufficient to say that we listen to our employees regarding their needs and we respond to them whenever possible.

At Federal Express, we view an employee's total pay as a multifaceted package that includes both cash compensation and fringe benefits. When we examine expenses incurred for total compensation, Federal Express spends approximately 51 percent of its annual operating budget on employee compensation and benefits. By most corporate standards, this is a high percentage for operating funds. Therefore, we must be extremely careful to balance the need of our employees with the need to soundly manage the financial aspects of our business. Because of the ratio of total employee compensation to other expenses, we examine new benefits for our employees very carefully as every benefit dollar comes from finite resources.

The current law under section 89 causes us to spend finite resources for activities that in no way benefit our employees. While we agree with the intent of the Congress to provide employees equal access to benefits, we do not agree with the means which have been enacted.

The proof of compliance has been an expensive, elaborate manipulation of data to prove that we are providing nondiscriminatory benefits when we are already doing so in theory, and then in practice.

Section 89 redefines the concept of benefit plans by organizing them along group demographics over which corporations have very little control. In Federal Express's case, the law takes our uniform approach to benefit plans and because of the legal technicalities and intricacies converts that plan into multiple plans.

In addition, we must develop automatic systems for testing benefit programs to prove nondiscrimination for tracking highly compensated employee movement from one plan to another. This basically creates havoc for plan administrators and causes us to incur significant expense in time and money to prove that we are in compliance when conceptually we knew we already were. With this additional expense, no additional benefits are provided to reward our employees efforts and no additional revenues are received by the Government. What have we gotten for our money?

It appears that other employers, not as dedicated to their employees, might opt for discontinuing employee health insurance programs or other benefit programs to avoid the expense and hassle of complying with section 89. This would lead to increased cost shifting to companies that do offer health benefits and to reductions in those benefits to compensate for additional costs. This would only complicate the spiraling crisis in health care costs and ultimately budget deficits, something we are all working to alleviate.

It is for these reasons that we support measures to simplify the nondiscrimination rules under section 89. Mr. Chairman, your bill, H.R. 1864 is a move in the right direction. It allows those employers who sponsor uniform nondiscriminatory plans a means to avoid the time and expense of proving compliance and opportunity to expand benefit programs to meet the needs of a changing work force.

Your insight into the realities of employee benefit programs is both welcome and appreciated. We at Federal Express are committed to advancing the state of the art in benefit programs to attract and retain the best qualified employees available and to reward our employees for their efforts in making our company grow and prosper.

We applaud your efforts and those of your cosponsors in developing this measure. We believe this proposal will lead to a more positive approach in developing productive strategies for expanding health coverage.

We encourage adoption of H.R. 1864. Thank you for the opportunity to express our support.

[The statement of Bonnie McKeever follows:]

Statement of
Federal Express Corporation

Mr. Chairman, and members of the Committee, my name is Bonnie McKeever. I am the Managing Director of Employee Benefits for Federal Express Corporation. I would like to thank you for this opportunity to testify in support of simplification of Section 89 . We have worked, through our membership with the Washington Business Group on Health, with the Section 89 Coalition and appreciate their role in suggesting modifications to the law.

Federal Express was founded in 1973, as an express air cargo service. Since that time, the company has expanded to offer the finest overnight document and package delivery service available. We currently handle over one million packages daily through our system. We now employ over 60,000 people across the country and our service is available to 99% of the population of the United States. Federal Express provides a very comprehensive package of medical, dental and vision benefits equally to all employees. Part-time employees receive the same coverage as full-time employees, as they have for over 15 years.

Our growth and prosperity are marked by the insight of our founder, Fred Smith, in recognizing both the need for such a service, and the benefit of our corporate philosophy, PEOPLE-SERVICE-PROFIT. This philosophy has as its cornerstone the people of the organization. The PEOPLE-SERVICE-PROFIT philosophy essentially means that by taking care of our people, they, in turn, will deliver the impeccable service demanded by our customers who will reward us with the profitability necessary to secure our future.

This philosophy is the very foundation of our success. It has led to the creation of progressive programs such as our Survey-Feedback-Action Program which is an annual survey to measure our employees' opinions concerning management leadership, satisfaction with pay and benefits, management fairness, whether we are doing a good job for our customers, and a host of other items. As the number of employees has grown from 30,000 to 45,000 to 60,000, it has been harder and harder to improve some of the measurement indices we derive from this survey. Historically, these measurement indices have only varied by a percentage point per year. In short, it is difficult to satisfy 60,000 people at one time. This year, however, the results of the survey have shown and increase of five full percentage points. This is the largest increase in the ten year history of this program. Employee satisfaction is very high, and our progressive programs have also received positive attention from outside the company. Federal Express has been rated as one of the "Ten Best Companies to Work for in America" (Levering, Moskowitz, and Katz - The 100 Best Companies to Work for in America), and ranked highly by *Working Mother, Black Enterprise* and *Business Month* magazines. We have just recently been granted the "Employer Responsiveness Award" by the Council on Economic Priorities. We cannot rest assured that the status quo is satisfactory, however, we can assume that we are responding properly to the expressed needs of our employees. This is one reason that we oppose government mandated benefits. We believe that through such mandates, our flexibility to offer innovative benefit programs to meet our employees' needs becomes limited. But that is not the subject at hand today. Let it be sufficient to say that we listen to our employees regarding their needs and we respond to them whenever possible.

At Federal Express, we view an employee's total pay as a multi-faceted package that includes both cash compensation and fringe benefits. When we examine the expenses incurred for "total compensation", Federal Express spends approximately 51% of its annual operating budget on employee compensation and benefits. By most corporate standards this is a high percentage of our operating funds, therefore, we must be extremely careful to balance the needs of our employees with the need to soundly manage the financial aspects of our business. In fact, we formally review all compensation programs every quarter and benefits plans every six months. Because of the ratio of total employee compensation to other expenses, we examine new benefits for our employees very carefully, as every "benefit dollar" comes from finite resources. The current law under Section 89, causes us to spend finite resources for activities that in no way benefit our employees. While we agree with the intent of the Congress to provide employees equal access to benefits, we do not agree with the means which have been enacted.

The Effect of Section 89

The proof of compliance has been an expensive, elaborate manipulation of data to prove that we are providing nondiscriminatory benefits when we are already doing so, in theory, and in practice.

Section 89 redefines the concept of benefit plans by organizing them along group demographics, over which corporations have very little control. In Federal Express' case, the law takes our uniform approach to benefit plans, and because of the legal technicalities and intricacies, converts that plan into multiple plans. As an example, you might have a single employee plan, a married employee plan, a married and/or single employee plan in an HMO. So, instead of having one HMO plan, there are now multiple plans requiring testing to determine if there is a discrepancy in treatment between highly and lower compensated employees. In addition, we must develop automated systems for testing benefit programs to prove nondiscrimination and for tracking highly compensated employee movement from one plan to another. This basically creates havoc for plan administrators, and causes us to incur significant expense, in time and money, to prove that we are in compliance when, conceptually, we knew we were already there. With this additional expense, no additional benefits are provided to reward our employees' efforts and no additional revenues are received by the government. What have we gotten for our money?

It appears that other employers, not as dedicated to their employees, might opt for discontinuing employee health insurance programs to avoid the expense and hassle of complying with Section 89. This would lead to increased cost shifting to companies that do offer health benefits and to reductions in those benefits to compensate for additional costs. This would only complicate the spiraling crisis in health care costs and ultimately budget deficits ... something we are all working to alleviate.

We should also be concerned about the impact of such regulation on maintaining a competitive stature in a global economy. It is our intent to continue to create well-paid, secure jobs in the United States. Section 89 only exacerbates that intent.

Impact in the Future

With the changes predicted in the demographics of the work force over the next ten years, it becomes more important than ever for employers to build flexibility in their employee benefit programs. This flexibility is discouraged by Section 89 as, once again, these flexible programs would take the form of different plans and would require separate testing.

It seems that Section 89 in design, rather than intent, punishes those employers who do provide benefits to their employees rather than attacking the problem of employees who are not offered health care coverage by their employers and count among the 37 million uninsured Americans. This clearly seems to be a well-intended mistake.

Simplification

It is for these reasons, that we support measures to simplify the nondiscrimination rules under Section 89. Mr. Chairman, your bill, HR1864, is a move in the right direction. It allows those employers who sponsor uniform, nondiscriminatory plans a means to avoid the time and expense of proving compliance and an opportunity to expand benefit programs to meet the needs of the changing work force. We are concerned, however, about how the bill deals with health care flexible spending account deferrals, particularly the treatment of deferrals for highly compensated employees as "employer contributions" and deferrals for non-highly compensated as "employee contributions". This will make the 133% benefits test a very close matter and will most likely discourage expansion of flexible spending accounts, again, one of the primary tools we can use to meet the needs of the changing work force. We understand that you are continuing work on this provision and would recommend the same treatment for deferrals by highly and non-highly compensated employees.

Your insight into the realities of employee benefits programs is both welcomed and appreciated. We, at Federal Express, are committed to advancing the "state-of-the-art" in benefit programs to attract and retain the best qualified employees available and to reward our employees for their efforts in making our company grow and prosper. We applaud your efforts and those of your cosponsors in developing this measure. We believe this proposal will lead to a more positive approach of developing productive strategies for expanding health coverage.

We encourage adoption of HR1864.

Thank you for the opportunity to express our support.

Chairman ROSTENKOWSKI. Thank you, Ms. McKeever.
Mr. Sandler.

STATEMENT OF ROBERT N. SANDLER, ASSOCIATE DIRECTOR, NATIONAL EMPLOYEE BENEFITS INSTITUTE

Mr. SANDLER. Thank you, Mr. Chairman and members of the committee.

My name is Robert Sandler. I am a partner in the law firm of Reinhart, Boerner, Van Deuren, Norris & Rieselbach and associate director of the National Employee Benefits Institute, and we appreciate the opportunity of presenting our testimony this morning.

The National Employee Benefits Institute is a nonprofit employer-sponsored organization established to represent Fortune 1000 corporate employers on legislative issues in the employee benefits area.

Chairman Rostenkowski's bill is, in our assessment, the best hope for simplification and we wish to express NEBI's support of the concepts contained in the proposed legislation, and ask Congress to consider specific changes that would make it less difficult for large employers and most other employers to satisfy the new proposed nondiscrimination test.

NEBI endorses the policy objective of providing tax favored treatment of employer-provided health benefits only if the tax benefits further the important social policy objective of making health benefits available to a broad cross-section of employees.

We also agree with the overall scheme of the simplification proposal; that is, a nondiscrimination test based on plan design and availability of benefits rather than on burdensome data collection requirements.

Furthermore, we agree with the chairman's rejection of a tax cap which would tax all employees on health benefit costs exceeding a fixed dollar amount per month.

We disagree, however, with certain specific provisions in the proposal and would like to propose some modifications and additions to H.R. 1864.

No. 1, considering the confusion and uncertainty generated by section 89 in this year, and further considering the fact that the effective date for the qualification rules, except for employee notification has been postponed until 1990, we propose that no discrimination testing be required in 1989, and that the effective date be postponed to testing years beginning in 1990.

No. 2, a number of our members, in making diligent efforts to comply with currently applicable law, have expended enormous amounts of time, money, and effort to comply. Our members have spent literally hundreds of thousands of dollars to comply with these rules.

We suggest that in fairness to those who made good faith efforts to comply, that employers be offered the option of applying the current rules for a 3-year period.

No. 3, H.R. 1682, as summarized by Congressman Crane this morning, provides for a 70-percent eligibility test. We propose a compromise of an 80-percent eligibility test.

No. 4, the bill should provide an actual coverage test as an alternative to the eligibility test. For example, plans would qualify if 70 percent of the employer's nonhighly compensated employees are actually covered under a core health plan, even if cost to the employee exceeds the threshold levels under the eligibility test.

We realize that the chairman has considered such an approach and rejected it since a number of employers whose plans are not subject to the qualification rules of the Internal Revenue Code, are not familiar with this test. However, we are merely suggesting that it be offered as an alternative to the eligibility test.

No. 5, the employee paid premium under the eligibility test should more accurately reflect what is actually being passed through to employees currently. We would propose that the levels be raised to $20 per week for individual coverage and $40 for family coverage.

Furthermore, the bill should provide for variations in these limits according to different geographic and demographic factors. In the discussion of the special temporary evaluation rule set forth in the Ways and Means Committee report on H.R. 4333, which became TAMRA, employers were specifically permitted to make such adjustments.

If a flat dollar amount must be utilized, we suggest that such limits be adjusted by applying solely the medical portion of the CPI. This would be a far more accurate barometer of the actual increasing cost of the benefits.

Because of rapidly escalating health care costs and differences in available health plans due to the size of a company, regional rate differences, et cetera, we would prefer to see maximum employee cost not stated as a precise dollar amount, but rather as a uniform percentage of wages or salary or a percentage of the total company cost of the benefit.

No. 6, the family aggregation rule should not apply to family members when both are highly compensated. This leads to the illogical result that each highly compensated family member has to include both his own benefit and that of his family members.

No. 7, the leased employee rules are still not helpful. There is no mechanism to require leasing companies to disclose the benefits their employees receive.

No. 8, lastly, I think we should have very quick advice on separate lines of business. It is very difficult for companies of the size of the members of NEBI to deal with the rules as they exist currently.

We appreciate the opportunity of offering our comments and are prepared to answer questions or provide any information that you might require. Thank you.

[The statement of Mr. Sandler follows:]

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Testimony on H.R. 1864
by the National Employee Benefits Institute

The National Employee Benefits Institute ("NEBI") appreciates the opportunity of presenting the views of its members to the Ways and Means Committee with regard to H.R. 1864.

The National Employee Benefits Institute is a non-profit, employer-sponsored organization which was established to represent Fortune 1000 corporate employers on key legislative issues in the employee benefits area. During a recent meeting of the NEBI Policy Board, we adopted a position favoring simplification of the Section 89 rules. Chairman Rostenkowski's bill is, in our assessment, the best hope for simplification. We wish to express NEBI's support of the concepts contained in the proposed legislation and ask Congress to consider specific changes that would make it less difficult for large employers and most other employers to satisfy the new proposed nondiscrimination test.

NEBI endorses the policy objective of providing tax-favored treatment of employer-provided health benefits only if the tax benefits further the important social policy objective of making health benefits available to a broad cross-section of employees. NEBI also agrees with the overall scheme of the simplification proposal, that is, a nondiscrimination test which is based on plan design and availability of benefits, rather than on burdensome data collection requirements. Furthermore, NEBI agrees with Congressman Rostenkowski's rejection of a "tax cap" which would tax all employees on health benefit cost exceeding a fixed dollar amount per month.

NEBI disagrees, however, with certain specific provisions in the proposal, and would like to propose some modifications and additions to H.R. 1864. NEBI suggests that Congress consider the following changes to the bill:

1. Considering the confusion and the uncertainty generated by Section 89, and further considering the fact that the effective date for the qualification rules (except for employee notification) has been postponed to 1990, we propose that no discrimination testing be required in 1989, and that the effective date for Section 89 discrimination testing commence in 1990.

2. A number of our members, in making diligent efforts to comply with currently applicable law, have expended enormous amounts of time, money and effort to comply with current nondiscrimination rules. Our members have spent literally hundreds of thousands of dollars to comply with these rules. We suggest that in fairness to those who made good faith efforts to comply with the current rules, that employers be offered the option of applying the current rules for a three-year period.

3. H.R. 1682, introduced by Congressman Crane on April 5, 1989, provides for a 70% eligibility test. We propose that the 90% eligibility test be changed to an 80% eligibility test. Many of our members have significant numbers of leased employees who will still have to be counted by the employer under certain circumstances. In addition, there are a number of part-time employees who work more than 25 hours per week. As a result, the 90% eligibility test may prove difficult to meet for a number of employers, even though virtually all rank and file common-law employees are eligible for and covered by the core health plans.

4. The bill should provide an actual coverage test as an alternative to the eligibility test. For example, an employer's plans would qualify if at least 70% of the employer's nonhighly compensated employees are actually covered under a core health plan, even if cost to the employee exceeds the threshold levels under the eligibility test. We realize that Congressman Rostenkowski has considered such an approach and rejected it since a number of employers whose plans are not subject to the qualification rules of the Internal Revenue Code are not familiar with this test. However, we are merely suggesting that it be offered as an alternative to the eligibility test.

5. The employee-paid premium under the eligibility test should be $20 per week for individual coverage and $40 per week for family coverage. These numbers would more accurately reflect the amounts that employers are currently passing through to employees than the $10 and $25 limits. Furthermore, the statute should provide for variations in these limits according to different geographic and demographic factors. In the discussion of the special temporary valuation rule set forth in the Ways and Means Committee Report on H.R. 4333 (which became the Technical and Miscellaneous Revenue Act of 1988), employers were specifically permitted to make such adjustments.

If flat dollar amounts are to be utilized for the $10 and $25 limits, we suggest that such limits be adjusted by applying solely the medical portion of the Consumer Price Index. This would be a far more accurate barometer of the actual increase in cost to the employer providing benefits.

Because of rapidly escalating health care costs and differences in available health plans (due to the size of a company, regional rate differences, etc.), we would prefer to see maximum employee costs not stated as a precise dollar amounts but, rather, as either: (a) a uniform percentage of wages or salary, or, (b) a percentage of the total company cost of the benefit. We suggest that reasonable maximums for employee cost would be 25% of company cost for individual coverage and 50% of company cost for family coverage.

6. The "family aggregation" rule should not apply to family members who are both (or all highly compensated employees). We can see no logic to the result under such circumstances that each highly compensated family member has to include both his own employer-provided benefits and that of his family members. The rule was more appropriately intended for families containing highly compensated and nonhighly compensated employees. We suggest that the "family aggregation" rule be limited to situations where there are family members who are highly compensated and nonhighly compensated.

7. We wholeheartedly agree with the change to the penalty for noncompliance with the qualification rules insofar as it eliminates imputed income for the employees. However, we believe that the excise tax should be a percentage of the employer's deduction of the benefit, rather than a percentage of benefits paid or incurred. In addition, the definition of a "de minimus" failure to comply with the qualification requirements in the proposed regulations is relatively narrow, and the potential excise tax that may have to be paid by the

employer could be enormous. This is particularly true with large employers, due to the large number of their employees. We suggest that the de minimum failure rule be expanded.

8. The benefits test language instructs us to take 133% of the smallest employer-provided benefit attributable to a plan that was used in the eligibility test; however, example number 3 makes use of the largest employer-provided benefit. Assuming that the intended standard is the smallest employer-provided benefit, we believe that adjustments for geographic and demographic factors should be permissible. Alternatively, we suggest that a weighted average of the premiums actually paid under all core plans utilized for the eligibility test should be employed.

Whether the smallest or largest employer-provided benefit is used, it is not clear whether the employer-provided benefit consists only of the employer after-tax cost. Are salary reduction amounts for nonhighly compensated employees taken into account at all in the benefits test? There seems to be no linkage between the proposed limits on nontaxable benefits for highly compensated employees and the amount of nontaxable benefits received by the nonhighly compensated employees.

If the purpose of the benefits test is to ensure that highly compensated employees do not receive a disproportionately higher level of employer premium than the level of employer premium that is available to the nonhighly compensated employees, then those noncore benefits that are available to nonhighly compensated employees must be brought into the benefits test equation. As written, the benefits test penalizes highly compensated employees for having any additional non-core benefits not used in the eligibility test, even though the same non-core benefits may be available to 100% of the nonhighly compensated employers. This inequitable treatment of salary reduction amounts, if retained, would severely restrict an employer's use of flexible benefits (cafeteria) plans.

We suggest that Mr. Rostenkowski's intent would be properly served if, for purposes of the benefits test, the denominator of the equation were to contain the employer-provided value, including employee salary reductions of all health plans or types of health plans that were available to 90% of the nonhighly compensated employees, and the numerator were to contain the value of all health plans meeting the eligibility requirements. This would credit the employer for providing non-core benefits to nonhighly compensated employees.

9. The leased employee exception is not helpful due to the fact that the leased employee rules are, themselves, unworkable; for example, there is no mechanism to require leasing companies to disclose the benefits their employees receive.

10. What is meant by "primarily core" benefits? We need immediate guidance on what kinds of plans are to be included in the eligibility test.

11. We request further guidance on separate lines of business. It is our understanding that the Internal Revenue Service has taken the position that if two members of a controlled group have the same SIC Code, that they may not be considered separate lines of business. We believe that this is an overly narrow reading of such rules.

We appreciate having had the opportunity to present the views of the members of NEBI to the Ways and Means Committee. We will be happy to answer any questions or provide any information to the Committee regarding our comments.

Chairman ROSTENKOWSKI. Thank you very much.

Mr. Ford.

Mr. FORD. Thank you very much, Mr. Chairman.

I would like to thank each panelist for their testimony. I have one of my constituents from Federal Express appearing on the panel.

Ms. McKeever, you have indicated earlier that you support the simplification bill H.R. 1864. Is there anything in this bill that you would like to see modified or changed as we move through the legislative process here?

Ms. MCKEEVER. Thank you for the opportunity to answer that question. As one of my copanelists said earlier, I think the rules of treating the highly compensated versus the noncompensated differently, as far as tax deferrals or deferrals on the flexible spending accounts, needs to be changed where it is treated the same for both.

Mr. FORD. Let me ask you this: What would be the benefit of that change to an organization like the Federal Express?

Ms. MCKEEVER. We want to keep it as flexible as we can. We want to be able to retain and attract employees, and I think if you start making it restrictive by saying you have got to treat the highly compensated different, that does not happen. We want to stay as flexible as we can to attract and retain employees.

Mr. FORD. Retain employees. Are you satisfied with the limit imposed upon employee contribution? And will those limits be satisfactory in light of the rise in the cost of health care?

Ms. MCKEEVER. I think that is a hard one to predict. Currently, it does not affect us, but I can see that in the future it will, because I think more and more employers are going to pass on health care costs to their employees. They have to. It is just becoming, as you well know, one of the fastest rising things around. So I think in the future it could have some problems for us.

Mr. FORD. With Federal Express being one of, if not the, largest employer in my area, about how much are you spending on your health care fringe benefit packages there?

Ms. MCKEEVER. This next year, we will spend just on health-related over $100 million, and that is a sizable sum and continues to increase like it does for everyone else. So we think we have to get more progressively involved in what is happening from a legislative perspective.

Mr. FORD. But in your testimony, once again, you do fully support the simplification bill here.

Ms. MCKEEVER. Yes, we do.

Mr. FORD. And hopefully some modifications in it.

Ms. MCKEEVER. Yes, we do.

Mr. FORD. All right. Thank you.

Thank you very much, Mr. Chairman.

Chairman ROSTENKOWSKI. Any other questions?

[No response.]

Chairman ROSTENKOWSKI. Thank you very much for joining us.

Next we have Mr. Nicholas, Mr. Raup, Mr. Kushner, Mr. Rumack. Welcome to the committee, gentlemen. We are looking forward to your testimony. You all know the ground rules.

If you will identify yourself for the record when you make your presentation, we would greatly appreciate that. Mr. Nicholas, would you like to begin?

STATEMENT OF RICHARD L. NICHOLAS, PRESIDENT, COMPLIANCE TECHNOLOGIES, INC., LA JOLLA, CA

Mr. NICHOLAS. My name is Richard Nicholas. I am the president of Compliance Technologies, Inc., a professional services firm specializing exclusively in the area of Government regulatory compliance as it relates to employee benefits programs arranged and managed by third-party administrators.

Mr. Chairman, members of the committee, I want to express my appreciation to you for your efforts in holding these hearings and for the opportunity you have provided me to appear before you today.

In great part, the failure of the Internal Revenue Service Code section 89 to be accepted by the employer public is due to the general lack of the media, accounting, and insurance industries to play a greater part in its evolution and announcing its enactment and the effect on employers in a timely and understandable manner. We believe that these industries have been remiss in their responsibility to communicate the entire story of section 89, complete with all the all too important legislative history of its development, which greatly influences one's perceptions of the importance of such a law in the overriding public policy goals which it attempts to achieve. Without an understanding of these motivations and with an undue emphasis placed on the law's administrative complexities, it is not surprising that public sentiment has evolved as it has.

During the last year, our firm has conducted informational seminars on section 89 throughout the United States on behalf of many administrators. We have literally addressed thousands of employers and performed many nondiscrimination tests. The conclusions we have drawn during this period vary considerably from those who put it in the press.

We have concluded that it is not what is known about section 89 that troubles employers but what is unknown. We have concluded that employers are not knowledgeable about the origins of section 89. They are not aware that $30 to $40 billion per year tax loss as a result of the tax favored status are employee benefit programs that they enjoy. Nor are they cognizant of the manitou of the Nation's uninsured population which we estimate to be nearly 37 million people.

They are not aware that section 89 was part of a delicate compromise that brought them reduced tax rates to the 1986 Tax Reform Act. They are not cognizant of the more financially significant possible consequences of the repeal efforts. The full taxation of employee benefits are mandated minimum employer sponsored health care programs.

Mr. Chairman, we believe that the failure of section 89 be accepted as a legitimate law was as a result of poor public relations programs. We believe that although no employer wants undue Government regulation, that when enlightened by the aforementioned history and rationale of section 89, and given a practical explanation how each requirement and test works, and why it was incorporated into law, employers have overwhelmingly accepted the basic objectives of the law and to put the public policy objectives of tax equity and greater access to health care for their fellow Americans.

It is nonetheless true that current section 89 language, although it accomplished these goals, is complex and requires a great deal of time and effort to comply with. Surely, 1864 is a big step in the right direction.

During the last 2 weeks, Network TPA of Phoenix, AZ, has conducted a survey of third-party administrators on behalf of Compliance Technologies to determine their feelings with respect to several proposed modifications which were thought to be of significant relevance to the broad section of employers supportive of the policy objectives of section 89 and likely to be given serious consideration by the committee.

This survey of over 100 third-party administrators represents more than 50,000 employers covering more than 5 million employees. A summary of the results follows.

Some form of section 89 administrative relief is required. While the bill provides us relief, it makes compliance more difficult and potentially more costly to many employers. For this reason, H.R. 1864 should amend and not replace section 89 by incorporating the new eligibility and benefit test as an alternative to compliance with current law.

The salary reduction provisions of the bill make achieving compliance unnecessarily costly and burdensome for those employers sponsoring cafeteria plans. We believe that the bill should be modified to define salary reduction amounts as those only having to do with health insurance premium contributions.

If the current section 89 rules are maintained as an optional method of compliance, we believe that the following 1864 provision should be used to modify current requirements.

Those provisions relate to the part-time employee exclusion, least employee exclusion, the ability to test union plans separately, a delay in the application of the program to former employees, the ability to forego testing and have highly compensated employees take the employer premium for health coverage's taxable income, and the change in the qualifications rules penalties.

Mr. Chairman, the replacement of section 89 with H.R. 1864 is a mistake from both the public policy and financial resources perspective. We believe that H.R. 1864 should be included as an alternative method of compliance along with the typification provisions extended to the current language.

A great many employers insurance consultants and advisors have expended considerable time and effort to understand, compile data, develop systems and comply with the law on a timely basis. To replace existing law with an entirely new set of standards would amount to a callous rebuff to those law abiding employers who have developed methodologies and information systems for long-term use.

Moreover, it is likely that many employers who have passed or would have passed the old test will fail under the new proposed methodology. In effect, because they have devoted the resources necessary to conduct the extensive testing required by current law, which we agree accomplishes the public policy and tax equity objectives it sets forth to do, they will be penalized in future years by having to cope with the change in rules midgame.

Mr. Chairman, we heartily support the premise that a less complicated methodology to demonstrate nondiscrimination is required. However, replacing existing language with H.R. 1864 is not the only way to accomplish this goal.

For many employers outside professional assistance will still be required to become fluent in the law's requirements and to conduct the tests. Data will still have to be collected, planned evaluations will still have to be determined, mathematical calculations still have to be made and satisfied in the provisions of the qualifications rules will still require expert assistance.

More importantly, many more employers will fail the new tests and be required to have their highly compensated employees subjected to even greater taxation. This is because many employers will not meet the $25 per week employee contribution limits for family coverage. Clearly, a host of new problems will develop as employers seek to achieve compliance and fall within these employee contribution guidelines.

Mr. Chairman, Compliance Technologies, Inc., TPA Network and third-party administrators who have voiced their concerns through our survey wish to commend you and the committee for you recognition of the need to provide administrative relief from the complexity of section 89.

However, we do not believe that the only way of spelling relief is H.R. 1864. By meshing the testing alternatives provided under the new rule and its administrative modifications with the current law, we believe that the greatest good will be done for the greatest number of people. We believe that it is what good government is all about.

[The statement of Richard L. Nicholas follows:]

Compliance Technologies inc.

PREPARED STATEMENT OF RICHARD L. NICHOLAS,
COMPLIANCE TECHNOLOGIES, INC.
MAY 3, 1989
U.S. HOUSE OF REPRESENTATIVES, COMMITTEE ON WAYS AND MEANS
PUBLIC HEARING ON HR 1864

My name is Richard L. Nicholas. I am the President of Compliance Technologies, inc., a professional services firm specializing exclusively in the area of government regulatory compliance as it relates to employee benefits programs arranged and managed by third party administrators (TPAs).

Mr. Chairman and members of the Committee, I want to express my appreciation to you for your efforts in holding these hearings and for the opportunity you have provided me to appear before you today.

Healthcare, once the exclusive burden of individuals and families, has grown dramatically in complexity, expense and scope. In the 1930's during the Great Depression, state and federal governments became significantly more involved in fulfilling responsibilities too difficult for individuals to accept. Thus began the beginning of a series of congressional actions to promote the social goal of providing various degrees of protection against the hardship of unemployment, disability, poor health and even death.

Proposing a variety of utopian solutions, the federal government, over the next several decades, enacted legislation responding to problems brought on by the growing complexity of a modern-industrial society. During this period we have seen the introduction of Social Security, Medicare, Medicaid, a host of new programs and services brought on with President Johnson's "Great Society", COBRA and a multitude of various state and federally mandated healthcare acts which affect the overwhelming majority of privately sponsored benefit programs. Obviously, government's success and ability to maintain this system has been wholly dependent upon the availability of increasingly difficult to obtain funds.

As the federal government's deficit became more burdened, the question of responsibility and where it should be placed also became more serious and complex. The assumption of risks by the federal government has created an obligation so large that it has become unlikely that even past promises will be fulfilled let alone the burden of new problems yet to develop. Articulated in statutes, rules, regulations and reimbursement techniques, in tax provisions and court decisions, the government, through public policy amendments has demonstrated its intent that an increasing share of this burden for financing healthcare costs will be borne by employers.

By requiring compliance with various rules and regulations, the government rightfully seeks to promote social goals that are thought to be common to its citizenry. Appropriately today, we discuss regulations which focus on making broad based access to healthcare at reasonable costs a reality while ensuring that the expense of such an enormous endeavor be allocated within the parameters of tax equity. We believe that these goals are fundamentally right and we understand that the methods employed in accomplishing them must always be comprehensive and often times necessarily complicated to ensure the desired outcome under every circumstance and situation.

Nonetheless, as the activities of the federal government proliferate in the area of regulation of healthcare programs, so too will the resources necessary for employers to keep abreast of and in compliance with the changes in existing laws and enactment of new ones. Although employers accept this challenge as a part of owning and managing their businesses, when the complexity and expense of meeting the administrative requirements of the law seemingly outweigh the social goals it seeks to accomplish, common sense and human nature dictate that these legitimate concerns be voiced. Accordingly, this is why we have gathered here today.

In great part, the failure of IRC Section 89 to be accepted by the employer public is due to the general lack of the media accounting and insurance industries to play a greater part in its evolution, and in announcing its enactment and affect on employers in a timely and understandable manner. Moreover, I believe that these industries have been remiss in their responsibility to communicate the entire story of Section 89 complete with the all too important legislative history of its development which greatly influences one's perceptions of the importance of such a law and the overriding public policy goals which it attempts to achieve. Without an understanding of these motivations, and with an undue emphasis on the law's administrative complexities, it is not surprising that public sentiment has evolved as it has.

Compliance Technologies, inc. specializes exclusively in the area of government regulatory compliance, including IRC Section 89 testing and analysis. We act as a support organization to third party administrators which design and administer employee benefits programs for single employers, unions, trade associations and multiple employer trusts. It is estimated that TPAs manage plans for more than one-quarter of all working Americans, that is, hundreds of thousands of employers and tens of millions of Americans. During the last year, our firm has conducted informational seminars on Section 89 throughout the United States on behalf of many of these administrators. We have literally addressed thousands of employers and have performed many nondiscrimination tests. The conclusions we have drawn during this period vary considerably from those reported in the press.

We have concluded that it is not what is known about Section 89 that troubles employers, but what is unknown. We have concluded that employers are not knowledgeable about the origins of Section 89. They are not aware of the $30-40 billion per year tax loss as a result of the tax favored status employee benefits programs enjoy, nor are they cognizant of the magnitude of our nation's uninsured population, estimated to be nearly 37 million people. They are not aware that Section 89 was part of a delicate compromise that brought them reduced tax rates through the 1986 Tax Reform Act. They are not cognizant of the more financially significant possible consequences of the repeal efforts brewing in Congress - the full taxation of employee benefits and/or mandated minimum employer sponsored healthcare plans. Mr. Chairman, we believe that the failure of Section 89 to be accepted as a legitimate law as a result of a very poor public relations program.

Mr. Chairman, we believe that although no employer wants undue government regulation, when enlightened by the aforementioned history and rationale of Section 89, and given a practical explanation of how each requirement and test works and why it was incorporated into the law, employers overwhelmingly accept the basic objectives of the law and support the public policy objectives of tax equity and greater access to healthcare for their fellow Americans.

It is nonetheless true that current Section 89 language, although it accomplishes these goals, is complex and requires a great deal of time and effort to comply. Surely HR 1864 is a big step in the right direction toward accomplishing the fundamental policy objectives of the Tax Reform Act of 1986 while providing a testing methodology that is significantly less complex. However, we contend that some of the promises that the bill presupposes are incorrect and that several modifications could lead to a more universally accepted and genuinely more equitable process.

During the last 2 weeks, Network TPA, Inc. of Phoenix Arizona has conducted a survey of third party administrators on behalf of Compliance Technologies, inc. to determine their feelings with respect to several proposed modifications which were thought to be of significant relevance to a broad section of employers, supportive of the policy objectives of Section 89 and likely to be given serious consideration by the Committee. This survey of over 100 TPAs represents more than 50,000 employers covering more than 5,000,000 employees. A summary of the results follows:

- Some form of section 89 administrative relief is required. While HR 1864 provides this relief it makes compliance more difficult and potentially more costly to many employers. For this reason HR 1864 should amend and not replace section 89 by incorporating the new Eligibility and Benefits Tests as an alternative to compliance with the current law.

- The salary reduction provisions of HR 1864 make achieving compliance unnecessarily costly and burdensome for those employers sponsoring cafeteria plans. HR 1864 should be modified to define salary reduction amounts as those having only to do with health insurance premium contributions.

- If the current section 89 rules are maintained as an optional method of compliance, the following HR 1864 provisions should be used to modify current requirements.

    - the new 25 hour per week part-time exclusion

    - the new leased employee exclusion

    - the ability to test union plans separately

    - the delay in application to former employees

    - the ability to forego testing and have highly compensated employees take the employer premium (employer-provided value) for health coverage as taxable income

    - the change in penalties for noncompliance with the Qualification Rules [section 89 (k)] from employees to the employer

Mr. Chairman, the replacement of Section 89 with HR 1864 is a mistake from both a public policy and financial resources perspective. We believe that HR 1864 should be included as an alternative method of compliance, along with its simplification provision extended to the current language. A great many employers, insurers, consultants and advisors have expended considerable time and effort to understand, compile data, develop systems and comply with the law on a timely basis. To replace existing law with an entirely new set of standards would amount to a callous rebuff to those law abiding employers which have developed methodologies and information systems for long-term use. Moreover, it is likely that many employers who have passed or would have passed the non-discrimination tests will fail under the proposed HR 1864 methodology. In effect, because they have devoted the resources necessary to conduct the extensive testing required by current law, which we agree accomplishes the public policy and tax equity objectives it sets forth to do, they will be penalized in future years by having to cope with a change in rules midgame.

Mr. Chairman, we heartily support the premise that a less complicated methodology to demonstrate nondiscrimination is required. However, replacing existing language with HR 1864 is not the only way to accomplish this goal. For many employers, outside professional assistance will still be required to become fluent in the law's requirements and to conduct the tests. Data will still have to be collected, plan valuations will still have to be determined, mathematical calculations will still have to be made and satisfying the provisions of the Qualification Rules will still require expert assistance. Yet more importantly, many more employers will fail the new tests and be required to have their highly compensated employees subjected to even greater taxation. This is because many employers will not meet the $25 per week employee contribution limits for family coverage. Clearly, a host of new problems will develop as employers seek to achieve compliance and fall within these employee contribution guidelines. These will include major cutbacks in benefits to keep employer costs affordable and the elimination of childcare tax-favored incentives. For many employees, the affect of employer decisions of this nature will be contrary to the public policy objectives we all seek to accomplish.

Mr. Chairman, Compliance Technologies,inc. and the third party administrators who have voiced their concern through our survey wish to commend you and the Committee for your recognition of the need to provide administrative relief from the complexity of IRC Section 89. However, we do not believe that the only spelling of relief is HR 1864. By meshing the testing alternatives provided by HR 1864 and its administrative modifications with the current law, we believe that the greatest good will be done for the greatest number of people. We believe that it is what government is all about.

Chairman Rostenkowski. Thank you, Mr. Nicholas.
Mr. Kushner.

STATEMENT OF GARY B. KUSHNER, CHAIRMAN, COMPENSATION AND BENEFITS COMMITTEE, AMERICAN SOCIETY FOR PERSONNEL ADMINISTRATION, AND PRESIDENT, KUSHNER & CO., INC., KALAMAZOO, MI

Mr. Kushner. Mr. Chairman, members of the committee, my name is Gary Kushner, and I am president of Kushner & Co., Inc., a national employee benefits consulting and administration firm based in Kalamazoo, MI. I also serve as the chairman of the compensation and benefits committee for the association I am representing here today, the American Society for Personnel Administration.

Although I will direct most of my comments to H.R. 1864, I would like to emphasize at the outset that the members of ASPA strongly support full repeal of this onerous law. We have been unable to find any evidence that the discriminatory practices which section 89 is intended to address are widespread or warrant the imposition of complex compliance burdens on employee welfare benefit plans.

Short of repeal, however, ASPA support interim steps to clarify and dramatically simplify the statute. ASPA does recognize H.R. 1864's attempts to address some of the major concerns raised with section 89, especially modification of the nondiscrimination tests. We also are encouraged by a number of the legislation's simplification rules which are included in my written testimony.

However, ASPA is extremely concerned about several problems with H.R. 1864. I have retested seven client's health plans under the H.R. 1864 proposal, and I believe the results demonstrate one of these problems quite well. Six of the seven plans were full flexible benefit plans offering between three and five health care options and providing all employees with the same number of credits with which to buy health care, varying only on their family status.

Of the six employers, five passed the existing section 89 rules. In all six plans, at least a minimum level of health coverage was provided. That is, no employee was able to opt out of health coverage entirely.

Nevertheless, since employees could elect a lower health plan and use the unspent flex dollars and other benefit areas or take them in taxable cash, all six programs failed the H.R. 1864 test on affordability. This seems particularly strange since the employer provided the flex dollars in the first place.

Further, H.R. 1864's treatment of salary reduction as employee contributions for nonhighly compensated employees, and as employer contributions for highly compensated employees, make these plans extremely inequitable and unfair.

As you might expect, this makes both the affordability rule and the 133-percent rule of the benefits test very difficult for cafeteria plans to meet. In fact, because of this discrepancy in treatment, cafeteria plans can fail these tests even in cases where the actual coverage of the lower compensated employees is as good or better than the coverage of the highly compensated employees.

This problem could be addressed by counting cashable credits and salary reduction contributions as employer contributions for both highly and nonhighly compensated employees for the bill's benefits and affordability tests.

Another problem with the legislation concerns the benefits tests. The benefits test contained in H.R. 1864 would require employers to compare the highest benefit received by any highly compensated employee to the lowest benefit of any lower compensated employee group with a distinct plan, thereby greatly reducing the chance that an apparently equitable plan will pass the 133 percent rule.

The retention of current law's allowance for averaging these benefits as an alternative test would eliminate this problem without sacrificing the original intent of section 89. It would also restore most employers opportunity for one-time-per-year data gathering and testing for highly compensated employees.

ASPA also feels that consideration should be given to modifying the "cliff effect" of the bill's eligibility test to a graduated scale based upon failure to meet the 90 percent standard.

Incidentally, since one of Congress' stated goals in the original section 89 legislation was to make more uniform various tax code treatments of employee benefit plans, a 70-percent eligibility test comparable to the retirement plan eligibility test could be considered here.

Additionally, we are concerned with the affordability portion of the test. Having faced 30-, 40-, and even 50-percent increases in health care benefit costs this year alone, many ASPA members are worried that even if they can meet the test's $10 and $25 thresholds today, they may not be able to do so in the near future.

For this reason, ASPA supports replacing the set dollar threshold with the maximum threshold measuring employee contributions as a percentage of health care coverage cost to employers, a reform which would not compromise section 89's intent to detect an employers discriminatory practices. At the very least, the set dollar threshold should be indexed to medical cost inflation.

Finally, ASPA is concerned with the bill's taxation of employer provided benefits for highly paid employees in that it alters the character and greatly expands the scope of the nondiscrimination rules and destroys the tax favored treatment of employer provided health benefits, which has proven to be such a successful social policy.

The original authors of the section 89 legislation thought that it would encourage employers to expand health care coverage to their employees. However, it has had quite the opposite effect. Short of repeal, only a well-thought-out reform package which considers all aspects carefully in the development and continuation of sound public policy could achieve Congress' desired effects.

I thank you for the chance to testify here today, and would welcome any questions later.

Thank you.

[The statement of Gary B. Kushner follows:]

Statement of Gary B. Kushner, on Behalf of the American Society for Personnel Administration

Mr. Chairman and members of the Committee, my name is Gary Kushner, and I am President of Kushner and Co., Inc., a national employee benefits consulting and administration firm based in Kalamazoo, Michigan. I also serve as the Chairman of the Compensation and Benefits Committee for the association I am representing here today, the American Society for Personnel Administration (ASPA). ASPA is the world's largest professional society devoted exclusively to excellence in human resource management. The Society's membership has grown to more than 40,000 since its founding in 1948, and represents individuals employed by companies which collectively employ more than 41 million people. ASPA includes managers from a cross-section of American business -- from large corporations to smaller family operations -- as well as governmental entities and not-for-profit firms.

On the front line as practitioners, innovators, managers and decision-makers, human resource professionals are challenged to balance our companies' needs for administrative cost-effectiveness with our employees' desire for fair and comprehensive welfare benefit plans. Human resource managers are in a unique position to provide practical guidance on employee benefit issues, and we encourage employers to offer competitive and diverse benefits packages. Therefore, you can understand why I am pleased to be given the opportunity to appear before this committee on the subject of Section 89.

Although I will direct most of my remarks to Chairman Rostenkowksi's Section 89 reform bill, H.R.1864, I would like to emphasize at the outset that the members of ASPA strongly support full repeal of this onerous law. We recognize that Section 89 was included in the Tax Reform Act of 1986 to discourage employers from using the tax-favored status of health and group term life insurance plans to favor their highly paid employees, at the expense of their remaining employees. However, we have been unable to find any evidence that such practices are widespread, or warrant the imposition of complex compliance burdens on employee welfare benefit plans.

Section 89 assumes that every non-exempt employer in America is guilty of providing benefits which favor highly compensated employees, and requires employers to prove their innocence through burdensome data collection and intrusive testing procedures. Any law which takes such an approach is invariably complex. Unfortunately, in the case of Section 89, instead of expanding health coverage to lower paid employees, employers are reducing or eliminating coverage to all of their employees. As one who deals with employee benefit plans every day, I would like to assure you that in trying to accomplish equitable treatment in benefit packages, Congress has created a law which is so complex, and imposes such substantial administrative burdens on employers, that it serves as a very effective impediment to employers who wish to expand the diversity and scope of their employee benefit coverage.

The much anticipated Section 89 regulations, which were so difficult to draft that they were issued almost four months behind schedule by the Internal Revenue Service, provide little relief from, and even less clarification of, a law which took effect on January 1 of this year. Although the regulations were published on March 7, I do not believe many plan sponsors are any closer to a clear understanding of exactly what this new law entails.

While the regulations do contain transitional relief for the law's less complex qualification rules, and relax compliance standards for the complicated non-discrimination tests for 1989, they do little to reduce the law's burdensome data collection and

testing requirements. In a few cases, the IRS uses the transition rules contained in the regulations to actually make the testing requirements more complicated, and, in at least one case, even seems to exceed its statutory authority. For example, the regulations require the 50% eligibility test as a prerequisite to using the 90% alternative coverage test, a provision not included in the original statute or its legislative history. Additionally, it is interesting to note that the relief provided in the regulations for employers of over 5000 employees might conveniently apply to exempt the Federal government.

What does Section 89 mean to employers? One ASPA member has told us that he expects his large company, which provides health care services, to spend $200,000 in staff time and consulting fees to complete first year testing. Another ASPA member, who is director of personnel at a community college, tells us that his employer will spend at least $10,000 to hire a consultant and purchase a computer program for its initial testing. Yet another ASPA member tells us his company will face first year compliance costs of $3000 for in-house staff time and $20-25,000 for outside consultant fees to assist in actuarial valuation and statistical evaluation of its plans. His company will face second year costs of $3000 for software and an additional $3000 for training an in-house expert on Section 89. Not one dime of this money will go toward actually improving benefits for any employees.

Even more discouraging is the effect of Section 89 on these companies' employees. One member reports that his company will delay, perhaps indefinitely, the implementation of a planned employee flexible benefit plan in response to Section 89. Another member reports that his company will be forced to scrap its employee-favored diversified benefits structure and return to its pre-1985 single health plan option for all its employees.

Employers are angry that they will have to spend considerable sums of money merely to prove what they knew all along -- that their plans are not discriminatory. Others are angry that they are being penalized for offering extensive, diversified benefits packages which best meet their employees' needs. One ASPA members told us that the most unfortunate aspect of Section 89 is that for all the money spent, most of his company's employees will never even be aware of Section 89, or its intended purpose.

Mr. Chairman, few issues have generated such a unified chorus of outrage from ASPA members as Section 89. Short of repeal, therefore, ASPA supports interim steps to clarify and dramatically simplify the statute. We would like to take this opportunity to comment on your legislation, H.R.1864.

ASPA recognizes you have taken steps in addressing some of the major concerns raised with the current Section 89 requirements. By replacing the law's non-discrimination tests with the eligibility and benefits tests you would save some employers considerable administrative time and expense. We also are encouraged by the legislation's limitation of testing to core health plans; the exclusion of part-time employees who work up to 25 hours per week; the proportional adjustment in employee premiums and employer-provided coverage for less than full-time employees; the safe harbor allowing employees to disregard for testing leased employees if their leasing company provides the employee qualified core health coverage, although we are concerned with the potential burden to employers involved in certifying that the coverage exists, and although a number of ASPA members feel very strongly that leased employees should be excluded altogether; the allowance for separate testing for collectively bargained plans, if in fact the allowance is on an optional basis; the repeal of the provision requiring the creation of an artificial highly compensated employee if none exists within the company; and the elimination of the sworn statement requirement, which imposed a substantial burden on the employer and has a deplorable impact on employee relations. Finally, ASPA recognizes that the legislation would allow a delay in the testing of former employees until 1990. We believe that you should take this one step further and eliminate this part of the testing requirement entirely.

While we are pleased that the legislation addresses these areas, ASPA is extremely concerned about several perhaps insurmountable problems with H.R. 1864. I have had the opportunity to re-test seven clients' health plans under the H.R.1864 proposal, and I believe the results demonstrate one of these problems quite well.

Six of the seven plans were full flexible benefit plans, offering employees between three and five health care options, and providing all employees with the same number of credits with which to buy health care, varying only on their family status.

Of the six employers, five were able to pass the existing Section 89 rules. All six plans provided a minimum level of health coverage; that is, no employee was able to "opt-out" of health coverage entirely. Nevertheless, since employees could elect a lower health plan, and use the unspent flex dollars in other benefit areas or take them in taxable cash, all six programs failed the H.R. 1864 test on affordability. This seems particularly strange in light of the fact that it was the employer who provided the flex dollars in the first place. Further, H.R. 1864's treatment of "salary reduction" as employee contributions for non-highly compensated employees, and as employer contributions for highly compensated employees, places these plans in an untenable position of being extremely inequitable and unfair for the highly compensated.

As you might expect, this makes both the affordability rule of the eligibility test and the 133% rule of the benefits test very difficult for cafeteria plans to meet. In fact, because of this discrepancy in treatment, cafeteria plans can fail these tests even in cases where the actual coverage of the lower compensated employees is as good or better than coverage of the highly compensated employees. This problem could be addressed by counting cashable credits and affordable salary reduction contributions as employer contributions for both highly and non-highly compensated employees for the bill's benefits and affordability tests.

It is interesting to note that in all six flexible plans I tested, the existence of a health care flexible spending account would have been severely restricted for highly compensated employees, despite the fact that all programs already passed the Section 125 non-discrimination tests, and, in particular, the 25% concentration test. Under H.R.1864, all six programs would fail the 133% cap.

Another problem with the legislation concerns the benefits test. Current law allows employers to compare the average benefit received by highly compensated employees with the average benefit received by lower compensated employees to determine plan compliance. However, the benefits test contained in H.R.1864 would require employers to compare the highest benefit received by any highly compensated employee to the lowest benefit of any lower compensated employee group with a distinct plan, thereby greatly reducing the chance that an apparently equitable plan will pass the 133% rule. The retention of current law's allowance for averaging these benefits, as an alternative test, would eliminate this problem without sacrificing the original intent of Section 89, and would also restore most employer's opportunity for one-time-per-year data gathering and testing for highly compensated employees.

The bill's eligibility test, while preferable in most cases to the current law's utilization of complex and burdensome nondiscrimination tests, also contains some potential problems which should be addressed. Under the eligibility test, if an employer misses meeting the 90% rule by only one employee, all highly compensated employees working for that firm would be taxed on all of their benefits. This could a problem for a great many employers, since meeting the 90% standard would be made tougher for some employers by the bill's exclusion of employees covered by collectively bargained plans. Consideration should be given to modifying this "cliff effect" to a graduated scale based upon failure to meet the 90% standard. Since one of Congress' stated goals in the original Section 89 legislation was to make more uniform various tax code treatments of employee benefits, a 70% test, comparable to the retirement eligibility test, could be considered here.

Additionally, we are concerned with the affordability portion of the test. Having faced 30%, 40%, and even 50% increases in health care benefit costs this year alone, many ASPA members are worried that even if they can meet the test's $10/$25 thresholds today, they might not be able to do so in the near future. This is especially true if these thresholds are indexed to growth in the wage rate, as they are in H.R.1864. For this reason, ASPA supports replacing the set dollar threshold with a maximum threshold measuring employee contributions as a percentage of health care coverage cost to employers, a reform which would not compromise Section 89's intent to detect an employer's discriminatory practices. At the very least, the set dollar threshold should be indexed to medical cost inflation. It would be truly unfortunate if Congress, by adopting an eligibility test which becomes harder and harder to pass as health care insurance costs continue to escalate, inadvertently pressured employers to reduce or eliminate health care coverage to employees. Ironically, the pressure to curtail coverage exerted by this legislation would be proportional to the rise in medical costs above the rise in wage rates, thus jeopardizing coverage when employees could least afford to purchase it on their own.

Additional changes to H.R.1864 could include requiring plans that have changes or re-enrollments mid-year to retest only if its highly compensated employees are treated differently than its lower compensated employees by the change; adopting a concept included in current law by delaying the effective dates for meeting the qualification rules; considering business travel accident and accidental death and dismemberment as de minimis fringe benefits, and not requiring testing; and allowing employers electing to test under current law some of the relief provided under H.R. 1864.

Finally, ASPA is concerned by H.R.1864's taxation of employer-provided benefits for highly paid employees in excess of the 133% benefits test. Aside from the fact that this new provision alters the character and greatly expands the scope of the non-discrimination rules, we would like to remind the Committee that Congress' designation and consistent tax-favored treatment of employer-provided health benefits has proven to be tremendously successful social policy. Employers currently provide health care coverage to 171 million people, 84% of the total private health care in the nation. We fear that, in the deficit-conscious atmosphere in Washington, a tax cap on employee health benefits, no matter how well-intentioned, has the potential to pull employer-provided benefits from the realm of social policy and drop them in the middle of the budget negotiating table. We strongly oppose any compromise of this sound public policy, especially for short term budgetary gains.

The original authors of the Section 89 legislation thought that it would encourage employers to expand health care coverage to their employees. However, it had quite the opposite effect. Only a well-thought out reform package which sets ideology aside in favor of sound public policy could achieve Congress' desired effects. Thank you for the chance to testify here today.

Chairman ROSTENKOWSKI. Thank you, Mr. Kushner.

Mr. Raup.

STATEMENT OF RICHARD A. RAUP, CHAIRMAN OF THE BOARD, SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS, AND PRESIDENT, BUSINESS ADMINISTRATORS & CONSULTANTS, INC., REYNOLDSBURG, OH

Mr. RAUP. Thank you, Mr. Chairman.

My name is Richard Raup. I am president of Business Administrators and Consultants, a TPA firm in central Ohio. Today I am here as the chairman of the board for the Society of Professional Benefit Administrators which represents over 400 TPA's around the country who serve many of the same clients that we have been talking about this morning.

With me today, as well, is Anne Lennan, who is the director of research, which has helped prepare much of what we are going to talk about today.

I would like to commend you, Mr. Chairman and the committee for the leadership you have taken in tackling this problem that we have found ourselves emersed in and how to timely and economically go after these section 89 tests.

Our written testimony does provide some suggestions that will address the technical and hands-on administrative problems that we have seen. However, in my oral testimony I would like to talk about what we think is still a very serious problem that has only been partly addressed by your particular bill.

That is the five qualification rules that fall under section 89(k). Your changing in your bill of the tax from the employee to the employer is a great first step, but it only treats the symptom, not the problem. The problem is that it is very unrealistic to have plans timely—put their written plan together and that notification be given to the employees prior to the effective date. It is about as unrealistic as expecting regulations to be issued the same day a bill is passed out of the Congress and signed by the President.

That problem became painfully aware when we read the regulations that were issued by Treasury, and began to compare those rules to the Department of Labor's rules that we all have been operating under in the reporting, notification, the legal requirements that are a part of that plan.

We have prepared and would like to submit with the rest of our testimony a side by side comparison of what those rules are and how they compare between both IRS and Department of Labor.

If these issues are not addressed, we feel that not only will the Government lose additional revenues, but many more Americans will be left without coverage. I think an example may point up this point as well as anything else we can do. It will be a personal example, and one of our own firm when in the first week of December we received a premium-increase notice from our own insurance carrier of over 54 percent. That put our family premium per month to $535. It was much more than we had anticipated paying, and we were left with having to find some other carrier or reducing benefits in a way to keep our costs down.

We succeeded in finding another carrier, effective January 1, to take over our benefits and keep the cost in line. But we did not receive either the policy or the benefit booklets until March. Well, under the section 89(k) rules, we would be in penalty under your bill owing a 34-percent excise tax for the amount of premium we would have to pay for the entire year.

It does not seem fair on one hand that that should happen. If that were the rule, and I go rolling the tape backward and replay what we did in January, I have a couple of options as an employer. I can say, "Well, gosh, we just can't change our program. We will have to pay the additional 54 percent, and of course that increases my companies tax deductible premiums which, of course, is going to lower your revenue."

On the other hand I can say, "Let's pass that cost back to the employees, and if that happens, there is going to be a number of our boys who will not be able to afford to continue buying health care."

That is one example and an example that happens with almost every employer out there at least once a year and sometimes more often than that.

Another situation even more onerous, and that is when you walk into work one morning and find in the headlines that the carrier that you had been buying your coverage from is no longer in business and it has been taken over by either the insurance department or by some other authority. You now have no benefits at all through your employer. It is virtually impossible to put a plan together in a reasonable period of time in which you can find coverage for your people and still be in compliance with the rules as laid out by section 89(k).

We would strongly suggest that the committee consider some relief there looking to the rules that have been enforced now for well over ten years by the Department of Labor for the notification and reporting requirements.

Thank you very much.

[The statement and attachment follow:]

SPBA SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS
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Testimony to the U.S. House of Representatives
Committee on Ways and Means
H.R. 1864, Simplification of Internal Revenue Code Section 89
May 3, 1989
Richard A. Raup, President
Business Administrators and Consultants, Inc.

THE SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS

2033 M Street, NW, Suite 605, Washington-D.C. 20036 (202) 223-6413

SPBA is the national association of independent Third Party Administration firms (TPAs) of employee benefit plans. It is estimated that one-third (1/3) of all U.S. workers, from every size and format of employment, are covered by employee benefit plans managed by such firms. Over 90% of the TPA firms known to be eligible for SPBA have joined. Firms must be independent at the Board level and derive at least 50% of their income from TPA services.

SPBA member TPA firms operate much like independent CPA or law firms...providing continuing professional outside claims and benefit plan administration for several client employers and benefit plans. Most of the plans include some degree of self-funding. SPBA is unique, not only in the large percent of benefit plans represented, but also because it includes every size and type of employment, such as: small business, big corporations, union, non-union, association-sponsored plans, and every industry & profession. Thus, SPBA is known for its candid insights, its broad perspective, and that it has no "axe to grind" for or against any particular industry or type of plan.

SPBA membership has grown over 700% in the past 7 years, with a current roster of about 400 TPA firms. This growth mirrors the expanding demand for TPA services...in large part because of the leading role SPBA members have played in successful health cost containment efforts, cost-efficient administration techniques for pension & health benefit plans, and attention to complex government compliance requirements.

Mr. Chairman, and members of the Committee, my name is Richard Raup. I am President of Business Administrators and Consultants, Inc., a Third Party Administration firm specializing in employer-provided health insurance plans. I am testifying today as the Chairman of the Society of Professional Benefit Administrators (SPBA), the national association of over 400 Third Party Administration firms. These firms administer employee benefit plans for small and large employers, state and local governments, union and non-union plans, and association-sponsored plans. As the spokesman for this diverse group, my comments will provide a broad perspective on the impact your bill will have on employer-provided welfare plans offered by many different types of employers. Anne Lennan, Director of Research for the Society of Professional Benefit Administrators, is accompanying me and will assist in any questions that you may have.

I would like to begin by commending you, Mr. Chairman, on introducing a bill that would eliminate many of the onerous administrative burdens imposed by the present Section 89 statute and Internal Revenue Service proposed regulations, issued in the Federal Register on March 7, 1989. The time and effort you have taken to understand the numerous problems confronting employers with respect to this law is greatly appreciated and will not be easily forgotten. Clearly, you have given careful consideration to employer complaints and responded with a practical structure that fulfills the statute's original policy objectives without undue complexity. Your bill is an example of true tax simplification.

The Society of Professional Benefit Administrators applauds the reduction of time-consuming and costly data collection that H.R. 1864 provides. While some large employers with many different types of benefit plans may still need computer software to facilitate compliance with H.R. 1864, most employers will be able to perform these tests without computer assistance. Although many member SPBA Third Party Administration firms have purchased expensive software systems and marketed Section 89 services in an effort to satisfy employers' compliance needs, these firms will gladly forego their investments for a more logical approach to nondiscrimination testing. SPBA would like to see more employer resources spent on providing benefits to employees rather than on legal and consulting fees. Our primary concern has always been focused on the establishment and continued growth of employer-provided welfare benefit plans. As you have recognized, Mr. Chairman, the present Section 89 works contrary to that goal.

Qualification Requirements

While H.R. 1864 addresses many of the major problems raised by employers, the bill fails to resolve a number of issues concerning the qualification requirements under present-law Section 89(k). Before discussing these issues, I would like to commend you, Mr. Chairman, for recognizing the injustice of penalizing employees for a mistake made by the employer and thereby replacing the present-law sanction for failure to comply with the qualification rules with an excise tax on employers. While this tax is correctly directed at the responsible party, it still remains an unnecessary threat for employers who are making a good faith compliance effort.

H.R. 1864 retains the qualification requirements under Section 89(k). Section 89(k) requires that certain employee benefit plans (i.e., accident or health plans under section 105 and 106, group-term life insurance plans under section 79, dependent care assistance programs under section 129(d), cafeteria plans under section 125(c), fringe benefit programs providing no-additional-cost services, qualified employee discounts, and employer-operated eating facilities under section 132) satisfy five requirements: 1) the plan must be in writing; 2) employees must receive reasonable notification of the benefits available under the plan; 3) the employees' rights under the plan must be legally enforceable; 4) the plan must be maintained for the exclusive benefit of employees; 5) the plan must be established with the intention of being maintained for an indefinite period of time. Since these requirements appear to be reasonable and straightforward, many employers assumed that they would not pose any problems for plans. However, that assumption was based on the Section 89 statute and legislative history as contained in the General Explanation of the Tax Reform Act of 1986, written by the Joint Committee on Taxation. After the issuance of IRS proposed regulations, the difficulties with these requirements became apparent for the first time.

The problem with the qualification requirements is that they place an unnecessary burden on employers to determine how their plans, which are already in compliance with similar rules under the Employee Retirement Income Security Act (ERISA), must be changed to comply. As stated in the IRS proposed regulations, the reporting, notification and written plan document requirements are "in addition to, and not in lieu of, any requirements otherwise imposed on employer-provided benefit plans by Title I of ERISA or any other provision of law" (p. 91B). Consequently, employers must spend time and resources comparing the new IRS proposed rules with those under ERISA, as contained in Department of Labor regulations (29 CFR §2520.-104). When employers ask themselves if this added expense is necessary given the existence of parallel requirements under ERISA, they are unable to derive an answer and thus conclude that the time and money required to perform this comparison is not well spent.

If the qualification requirements that differ from those under the ERISA Department of Labor regulations serve an important purpose, then the effort employers must expend is justified. However, if these differences fail to serve any reasonable purpose, then the qualification requirements are deserving of the same criticism that the present-law nondiscrimination rules have received. That is, the requirements force employers to waste resources in an effort to prove something to the IRS that the employer already knows. Employers strongly resent having to satisfy these IRS requirements when they have already satisfied similar requirements for the Department of Labor.

Employers and plan administrators recognize that the requirements under the Department of Labor regulations with respect to the writing, reporting and notification of employee welfare plans were established for valid reasons. The protection of plan participants in employee benefit plans is a well-respected purpose of these regulations. The Department of Labor gave careful consideration to these rules, reflected on comments from plan administrators and based on those responses, issued final regulations that were accepted by employers.

In contrast, when employers ask themselves why the IRS has issued proposed regulations that differ from Department of Labor rules, they are unable to find any reason other than to raise revenue. Many employers believe that the IRS is purposely trying to set up a trap for the unwary. For example, a struggling small employer who can not afford to hire a benefit attorney and simply does not have the time to spend analyzing the new IRS Section 89 proposed regulations will most likely assume, based on an initial reading, that the summary plan description required under Department of Labor rules will satisfy the Section 89 notice requirement. If this small employer is unable to hear the speeches of IRS and Treasury Department officials who have been warning employers to closely examine the contents of the summary plan description to ensure Section 89 compliance, this small employer is most likely to be ensnared in the qualification trap.

Notification - Under the notification requirement in the Section 89 proposed regulations, all eligible individuals must receive notice of the terms of the plan "prior to the first day on which coverage is provided under an insured or insurance-type plan or benefits are available under any other type of plan and prior to the effective date of any material amendment, extension or modification of such coverage or benefits, and no later than a reasonable time prior to the availability of any election with respect to participation under such plan" (Q&A 5 (g)(1)). In the following paragraph, Q&A 5 (g)(2), the proposed regulations permit a period of 60 days to satisfy the notice requirement if there is a modification to the plan (including any change in plan design).

These regulations conflict with similar rules under Department of Labor regulations. While the "material terms" of a plan that must be included in the IRS notice are also required in the Department of Labor summary plan description, the Department of Labor regulations give employers 120 days to furnish this information to plan participants under a newly established plan and 210 days in the case of a modification to a plan already in existence. In many cases, this length of time is not needed. However, the Department of Labor provided this period for the exceptional cases where an employer and insurer or third party administrator (TPA) can not agree on the legal wording of the plan.

The process of choosing the correct wording for the summary plan description can be protracted. For example, on March 1 an employer decides to establish a new plan for employees with coverage beginning on April 1. The insurer or TPA prepares a summary plan description draft which is sent to the employer for approval. It is not unreasonable for the insurer or TPA to take one to two weeks in preparing the draft. When the draft summary plan description arrives in the employer's office, the employer usually does not drop all pressing business matters to examine the document. Instead, the employer may need one to two weeks to thoroughly read the document and feel confident in sending it to the next level of review, the employer's benefit attorney. By the time the attorney receives the draft document, the effective date of the plan (April 1) has already arrived. If the attorney approves the draft, the insurer or TPA needs at least a week to ten days for copying the document and mailing it to the employer for distribution to employees. However, if the attorney objects to certain provisions, the summary plan description is returned to the insurer or TPA for redrafting and the approval process begins again. This approval process may seem excessive or unnecessary; however, it is no more excessive or unnecessary than the IRS and Treasury Department approval process for regulations.

Delays in the effective date of coverage will result from the IRS notification requirement. If an employer decides on March 1 to create a new plan for employees with an April 1 effective date, insurers and TPAs will have to inform the employer that coverage should not become effective until all parties (the employer, benefit attorney, etc.) have agreed on the technical language of the summary plan description. The employer must be warned that if the parties can not agree before the effective date of the coverage or within 60 days after the effective date of any future plan modifications, the employer may be in violation of the qualification requirements. Under your bill, Mr. Chairman, this violation would trigger an employer excise tax equal to 34% of the coverage cost (i.e., the premium cost, as mentioned in the Joint Committee on Taxation staff description of H.R. 1864).

While the Section 89 proposed regulations provide a correction period of 90 days in the case of a de minimis failure with respect to the notification requirement, this grace period fails to reduce employers' anxiety. For an employer to use this grace period, the employer must demonstrate that a good faith effort was made. A clear definition of a good faith effort is not provided in the proposed regulations. Employers are concerned that their definition of a good faith effort may not coincide with IRS' definition. The proposed regulations empower the IRS to use discretion when enforcing this good faith compliance provision and leave the employer subject to the whims of IRS auditors.

In creating the notification requirement under Section 89(k), Congress attempted to ensure that employers would inform plan participants about the coverages available. However, it is customary for employers to provide employees with summaries of available plans (different from summary plan descriptions) prior to election periods so that employees may make informed decisions as to which benefit plan would meet their individual needs. These summaries are usually about three pages in length and do not contain all the information that is required in the summary plan description. Based upon these summaries, employees have enough information to select a benefit plan without being burdened with numerous summary plan descriptions that employees would never have the time or curiosity to read. After an employee selects a benefit plan, the summary plan description follows within 120 days and upon receipt the employee can then become well-versed in the details of the plan.

The Department of Labor regulations acknowledge the practices in operating an employee benefit plan by requiring summary plan descriptions to be given to plan participants. By contrast, the IRS proposed regulations require that all eligible employees (defined as those individuals who participate under the plan or are described in the plan as eligible to participate) must receive notice of the terms of the plan. As mentioned above, eligible employees are not interested in receiving detailed information about a plan until they are actually participating in the plan.

More importantly, employees have traditionally considered the receipt of detailed plan information to signify that coverage is is effect. Employers are concerned that employees who receive numerous notices describing different benefit plans will assume that they are covered under all these plans. H.R. 1864 should be amended to require that detailed plan information be given only to plan participants.

Single Written Document - Changing the notification requirements under H.R. 1864 to coincide with those under ERISA necessitates a corresponding change in the single written document requirement. H.R. 1864 should be amended to allow employers to satisfy this requirement within 120 days after the notice is furnished to employees.

Legally Enforceable - Under the legally enforceable requirement as described in the IRS proposed regulations, employers are prohibited from exercising discretion with respect to granting or denying coverage and eligibility to employees unless the discretionary methods used are clearly explained in the plan documents and communicated to plan participants. For example, health coverage that is conditioned on a qualified medical opinion of a physician and a managed care program are considered permissible discretions. The purpose of this rule is to prevent an employer from favoring certain employees over others with respect to the receipt of employee benefits after the terms of the plan have been established and explained to participants. At first glance, it would be difficult to argue against a rule having such an honorable intent. However, situations that arise in the ordinary operation of employee benefit plans demand a change in the impermissible discretion rules.

While the IRS recognized that the legally enforceable requirement had to contain safeguards to protect the viability of managed care programs, the IRS failed to see the need for employer discretion in other areas. For example, an employee's claim is denied under the plan and the employee appeals the denial under ERISA review rights only to be told that the plan is not required to pay the claim. Frustrated and convinced that the plan language indicated otherwise, the employee decides to file suit against the employer for misrepresenting the benefits provided under the plan. The employer, concerned about the cost of legal advice to defend the plan language, chooses to pay the employee's claim instead. However, the employer can not make this choice without considering the consequences under the legally enforceable requirement. If the employer fails to amend the plan document to reflect the new coverage provided to this one employee or fails to continue the new coverage for at least 12 continuous months, the employer will be in violation of the qualification requirements and subject to an excise tax. H.R. 1864 should be amended to allow an employer to pay this one claim without expanding coverage to all plan participants for a 12-month period.

In addition to the situation described above, there are other circumstances that warrant a relaxation of the legally enforceable requirement. For example, an employer may choose to assist a sick lower-paid employee with medical claims that are not covered under the company plan. However, the employer can not afford to extend this benefit to all employees for 12 consecutive months. Under the IRS rule, employers will no longer be able to help employees when they are in need for fear of incurring a penalty tax.. Although Congress focused on eliminating discretion in favor of the highly compensated employees when creating the legally enforceable requirement, this rule will probably hurt nonhighly compensated employees more often.

Indefinite Period of Time - A benefit that is in effect for 12 consecutive months is considered to have satisfied the requirement that a plan be established with the intent of being maintained for an indefinite period of time. The IRS proposed regulations permit a plan with coverage in effect for less than 12 months to satisfy this requirement if the employer can demonstrate that there is a substantial business reason for modifying or terminating the plan. However, changes in insurance carriers or health care providers are not considered valid reasons for modifying or terminating plans.

While the IRS must be commended for giving financially distressed employers a reprieve from the 12-month rule, the IRS overlooked other circumstances that deserve special treatment. For example, a small employer contributes to a group plan because the cost of providing coverage to employees is otherwise prohibitive. If the group plan experiences financial difficulty and can no longer pay claims, the small employer could be left with substantial unpaid claims and may be unable to find other coverage at a reasonable cost. H.R. 1864 should be amended to remove the qualification penalty tax when an employer's group plan becomes insolvent.

Additional Recommendations for H.R. 1864

Employee Contribution Rates - Indexing the employee contribution rates to average wage growth poses insurmountable problems. With the rapidly escalating health care inflation rate, employers will be required to pay an increasingly greater portion of health insurance costs. If the employer is forced to absorb these rising costs and thus shelter employees from this national problem, the employer will respond in one of three ways: 1) eliminate coverage; 2) raise deductibles; or 3) reduce the level of benefits offered. In raising deductibles, another form of discrimination will surface because only higher-paid employees will be able to afford to pay the deductibles. To prevent this, H.R. 1864 should be amended to index the employee contribution rates to the medical inflation rate or replace employee dollar limits with an employer-paid percentage of the total health care cost.

Another problem with the employee contribution rates concern plans that employ composite rates. Under these plans, single employees and employees with families pay the same amount for health insurance even though they derive different benefits. H.R. 1864 should be amended to permit the existence of composite rate funding structures where the composite rate does not exceed the average of the maximum single and family employee contribution rates.

Testing Date - H.R. 1864 retains the present-law nondiscriminatory provision requirement for the selection of a testing date. Under this requirement, any provision of a plan may be deemed discriminatory even if the plan passes the numerical nondiscrimination tests. Since this is a subjective test, employers are concerned that the IRS may challenge any testing date the employer has chosen. Employers fear they will have to defend their choice of testing dates every day of the year. H.R. 1864 should be amended to provide the employer with more security in his choice of testing dates; the IRS' power to challenge testing dates should be checked.

Definition of Plan - Under H.R. 1864, an employer's failure to meet the eligibility test will result in the inclusion of the value of all health coverage in the highly compensated employees' taxable incomes. This penalty poses problems for employers who maintain a single coverage plan that meets the eligibility test and an employee-pay-all family coverage plan that fails. While H.R. 1864 is not clear on this point, it appears that the failure of the family coverage to meet the eligibility test would result in the taxation of the value of single coverage for highly compensated employees. H.R. 1864 should be amended to apply the penalty tax to only the benefit that fails and not to all benefits. That is, the definition of a plan for purposes of the penalty taxes should be limited to individual benefits.

State and Local Governments - H.R. 1864 amends the definition of highly compensated employees so that an employer does not have to consider an officer a highly compensated employee when no officers are receiving compensation in excess of $45,000 a year. While this amendment was included in H.R. 1864 to facilitate Section 89 compliance for state and local government plans, problems still remain. Branches within state and local governments usually have very different benefit structures primarily because the benefits are funded from different taxes. For example, the benefits provided to employees in one branch of government may be funded by a lean state motor vehicle tax, while the benefits for another branch may be funded by a fat sales tax. If these branches can not pass the separate line of business test, they must be aggregated for testing purposes and may not pass the benefits test under H.R. 1864. H.R. 1864 should be amended to allow state and local governments to test separately regardless of whether they can pass the separate line of business test.

Excise Tax - The legislative language of H.R. 1864 fails to clearly coincide with the Joint Committee on Taxation (JCT) staff description of the 34% excise tax imposed on employers for failing to satisfy the qualification requirements. The legislative language states that the tax is equal to 34% of "the amounts paid or incurred during any taxable year." The JCT staff description states that the 34% excise tax is based on the premium cost calculated according to the health care continuation rules. To eliminate any potential confusion, the legislative language should be amended to reflect the intent of the JCT explanation.

Cafeteria Plans - H.R. 1864 poses major problems for cafeteria plans. As the bill is presently worded, the use of salary reduction plans is prohibited. As the cost of health insurance has risen, employers have turned to the salary reduction arrangement in an effort to control cost and thereby have been able to sustain the existence of plans.

Valuation Method - H.R. 1864 retains the present-law rule for determining the value of employer-provided benefits. Under this rule, an employer may use premium cost or any reasonable valuation method until the Secretary of the Treasury issues valuation tables. H.R. 1864 should be amended to allow valuation based on premium cost even after these tables are issued.

Thank you, Mr. Chairman, for giving careful consideration to my testimony. Your willingness to examine the impact of your proposal is greatly appreciated and will certainly bring you into high regard with employers throughout the country. I look forward to further discussions with you concerning this important matter.

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Side-by-Side Comparison of the Department of Labor Requirements for Summary Plan Descriptions and the Internal Revenue Service Section 89 "Writing" and "Notification" Requirements

	DOL	IRS
Timing of plan information to participants	In general, the summary plan description must be distributed to participants within **120 days** after the effective date of a newly established plan.	In general, all "eligible individuals" must receive a "notice" containing a summary of **the plan prior to the first day on which coverage is provided and prior to the effective date of any amendment, extension or modification of benefits, and no later than a reasonable time prior to the availability of any elections.** The "notice" must contain a statement that a "single written document," explaining further the provisions in the "notice," is available for inspection and that the terms of the "notice" are "legally enforceable."
Timing of modifications to participants	A summary of any plan modification (whether a substantial change in coverage or simply a clarification) must be provided to plan participants no later than **210 days** after the close of the plan year in which the modification was adopted. This summary must be filed with the Secretary of Labor no later than 210 days after the close of the plan year in which the modification was adopted.	A plan modification must be provided to plan participants no later than 60 days after the effective date of the modification. While the IRS would prefer to have plan participants notified of modifications prior to the effective date (as noted in the regulations), a 60 day grace period is permitted.
Plan information available upon request	The plan administrator must furnish certain material to individual participants upon their request. The plan administrator must make certain material available to participants and beneficiaries for inspection at reasonable times and places. The administrator shall, upon written request of any participant or beneficiary, furnish a copy of the latest updated summary plan description, plan description, and the latest annual report, any terminal report, the bargaining agreement, trust agreement, contract, or other instruments under which the plan is established or operated. The administrator shall make copies of the plan description and	A "single written document" (including all related documents incorporated by reference) must be available for inspection. This document must provide an explanation of the "notice" (mentioned above). Provided that the "notice" is given to participants prior to the first day of coverage, the "single written document" need not be completed until 120 days after the effective date of the new plan or modification. The employer need not provide a copy of the "single written document" to all "eligible individuals" unless they request the information. Note: If the "notice" requirement is not satisfied, the "single written document" along with all

	DOL	IRS
	the latest annual report and the bargaining agreement, trust agreement, contract, or other instruments under which the plan was established or is operated available for examination by any plan participant or beneficiary in the principal office of the administrator and in such other places as may be necessary to make available all pertinent information to all participants.	modifications must be in writing prior to the first day of coverage.
What must be included in plan information?	What follows is an overview of the contents of a summary plan description. The summary plan description shall include: the name and address of the employer or trustee of the plan (for a collectively bargained plan, a statement that a complete list of the employees and employee organizations sponsoring the plan may be obtained upon written request to the plan administrator); the type of administration of the plan, e.g. contract administration, insurer administration; if a plan is maintained pursuant to a collective bargaining agreement, a statement that the plan is maintained as such and that a copy of any such agreement may be obtained by participants and beneficiaries upon written request; eligibility requirements, including a statement of the conditions pertaining to eligibility and a description or summary of the benefits (in the case of a medical care plan providing extensive schedules of benefits, only a general description is required if reference is made to detailed schedules of benefits which are available without cost to any participant who so requests); a statement identifying circumstances which may result in disqualification, ineligibility, or denial, loss, forfeiture or suspension of any benefits that a participant or beneficiary might otherwise reasonably expect the plan to provide on the basis of the description of benefits; the sources of contributions to the plan and the method by which the amount of contribution is calculated; the identity of any funding medium used for the accumulation of assets through which benefits are provided; the procedures to be followed in presenting claims for benefits under the plan and the remedies available under the plan for the redress of claims which are denied in whole or in part; the statement of ERISA rights; a summary of the plan's termination procedure.	The "notice" that must be provided to "eligible individuals" must contain a fair and complete summary of the terms of the plan that are reasonably likely to be of significance to an "eligible individual." These terms must include at least the following: a general description of who is eligible to participate in the plan; a general description of the coverage or coverages offered (including the general types of benefits provided under the plan, basic limitations on such benefits and required deductibles and co-payments); the timing and method of any election to participate; the cost to the employee relating to the plan, whether by way of salary reduction or employee contributions; the method by which a copy of the plan may be obtained; and the name and means of contacting a person from whom to request further information about the plan. The "single written document" (to be maintained in an employer's file) must include a statement that the plan is "legally enforceable" and that the plan is maintained for the exclusive benefit of employees. Any information or term required by any other applicable provision of the Code or accompanying regulation must also be included. Most of the information included in the "single written document" will describe an employee's rights to be covered by, participate in, or benefit under a plan. This information must not only include all the information required in the "notice" but also the following: terms relating to the periods during which coverage or benefits are provided; the extent to which elections are irrevocable; the manner in which employer contributions may be made; conditions regarding a participant's qualification or continued qualification for coverage, including pre-existing condition limitations; provisions relating to the procedure under

	DOL	IRS
		which claims are to be made and evaluated for reimbursement; provisions relating to health continuation coverage; and the procedures or circumstances under which the plan may be terminated.
Method of Notification	The plan administrator shall use measures reasonably calculated to ensure actual receipt of the material by plan participants. Material which is required to be furnished to all participants covered under the plan must be sent by a method or methods of delivery likely to result in full distribution. For example, in-hand delivery to an employee at his or her worksite is acceptable. However, in no case is it acceptable merely to place copies of the material in a location frequented by participants. It is also acceptable to furnish such material as a special insert in a periodical distributed to employees such as a union newspaper or a company publication if the distribution list for the periodical is comprehensive and up-to-date and a prominent notice on the front page of the periodical advises readers that the issue contains an insert with important information about rights under the plan and the Act (ERISA) which should be read and retained for future reference. If some participants are not on the mailing list, a periodical must be used in conjunction with other methods of distribution such that the methods taken together are reasonably calculated to ensure actual receipt. Material distributed through the mail may be sent by first, second, or third-class mail. However, distribution by second or third-class mail is acceptable only if return and forwarding postage is guaranteed and address correction is requested. Any material sent by second or third-class mail which is returned with an address correction shall be sent again by first-class mail or personally delivered to the participant at his or her worksite.	The Section 89 regulations reference the DOL regulations (29 CFR §2520.104b-1(b)(1)) for guidance on the method of notification. Thus, the same notification method applies for both IRS and DOL.
Who receives the plan information?	In general, the summary plan description must be distributed to anyone who is considered "covered" by the plan and to anyone who is receiving benefits. However, the summary plan description can be distributed to a person before he or she becomes covered, such as when a new employee begins employment.	All "eligible individuals" must receive a "notice" (summary of the plan). An "eligible individual" is not someone who derives eligibility solely through another individual, such as dependents. An "eligible individual" is someone who participates under the plan or is described in the plan as eligible to participate. An "eligible individual" includes someone whose participation under the plan is conditioned upon an election not yet made

	DOL	IRS
		or the passage of a waiting period required under the plan. In addition, an "eligible individual" includes someone who is a "qualified beneficiary" (as defined in COBRA). For purposes of notifying "qualified beneficiaries," the definition of "eligible individuals" includes those who derive eligibility through an employee.
Reporting Requirements	The administrator of a plan must file with the Secretary of Labor a copy of the summary plan description on or before the last date on which a summary plan description may be furnished to plan participants (i.e., 120 days after the effective date of a newly established plan).	The Internal Revenue Service does not require a copy of either the "notice" or the "single written document" to be filed with the Service. However, the employer must keep this information on file.

Society of Professional Benefit Administrators

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Chairman Rostenkowski. Thank you, Mr. Raup.

Mr. Rumack.

STATEMENT OF FREDERICK W. RUMACK, DIRECTOR OF TAX AND LEGAL SERVICES, BUCK CONSULTANTS, INC., NEW YORK, NY

Mr. Rumack. Good morning. I am Frederick Rumack, director of tax and legal services for Buck Consultants, one of the Nation's leading employee benefit consulting firms.

As a benefit consultant to numerous large and midsize employers, Buck has witnessed numerous problems in assisting employers in applying the current section 89 rules and, thus, is in a position to analyze and evaluate the impact of H.R. 1864 on employer-sponsored health plans.

From our vantage point, attempting to comply with the existing section 89 rules has been very costly for many of our clients. Unfortunately, the costs to some of our clients have run into the hundreds of thousands of dollars.

First, however, let me begin by congratulating Chairman Rostenkowski for trying to rectify the situation by introducing legislation to simplify the section 89 rules. It is much needed and we are very supportive of the simplification changes. However, there are a number of areas in the bill that should be changed.

Before I turn to the specific provisions in the bill, however, I would like to first suggest that the effective date of section 89 should be delayed at the very least until January 1, 1990. As we see it, there is mass confusion amongst plan sponsors concerning the future direction of section 89, and many employers have now taken a wait-and-see attitude because of the uncertainty.

Furthermore, it seems clear that any changes in section 89 are not likely to be enacted until the fall. A delay would grant employers time to react to and comply with the new rules and prevent needless additional expenditures in complying with the current rules that are going to be revamped by Congress anyway. The delay would also give IRS time to provide the needed guidance.

Now as concerns H.R. 1864. As we understand it, the bill would replace the current section 89 nondiscrimination rules applicable to statutory employee benefit plans. For accident and health plans, the new rules would contain a 90-percent availability test and affordability test, both of which are applicable to nonhighly compensated employees and a general nondiscrimination provision.

If these tests are met, then the employer-provided accident or health benefits provided to highly compensated employees would be generally tax favored up to 133-percent limit. If these tests are not met, then the total value of employer-provided accident or health benefits for highly compensated employees would be fully taxable.

For purposes of determining what health plans may be considered available in meeting the 90-percent availability test, the bill limits mandatory employee contributions for qualified core coverage by nonhighly compensated employees to $10 a week for single coverage and to $25 for employee and family coverage. These limits under the bill would be indexed to increases in the national average of wages.

Buck believes that the indexing of these employee contribution limits should be directly related to increases in health care costs for employers. These costs for employers generally have increased and are projected to increase at a much higher rate than the national average of wages. Buck's actuaries currently project a trend factor for employee health care costs of at least 15 to 20 percent while the national average of wages is likely to increase at more than 6 or 7 percent a year.

We believe an index could be developed to measure the increases in employer health costs and that this index should be used to determine the increases in the $10 and $25 employee contribution limits. If the national average of wages is used as an index, the net result over time will be a dramatic increase in employer health costs as compared to employee costs.

This increased cost is likely to result in significant reductions in the amount of health care coverage provided by employers to both active and retired employees. This should be avoided.

As concerns the testing rules, we believe that the rules should allow employers to exclude from testing altogether collectively bargained employees covered by multiemployer plans because of the difficulty in getting appropriate data from these plans. Also, employers should have the option of testing collectively bargained employees who are not a multiemployer plan separately as the bill now provides or by including them with nonunion employees in testing.

Another issue concerns the calculation of the 133-percent cap on tax-favored benefits for highly compensated employees. The rule that the lowest value core health plan among the best available core health plan for any nonhighly compensated employee within the 90-percent group, would be the value to be multiplied by 133-percent simply serves to reduce unjustifiably the overall level of tax-favored benefits to be provided for highly compensated employees.

Instead of using the lowest value plan as a base, we recommend that the average value of core plans available to nonhighly compensated employees be used as the base for calculating the 133-percent cap. This would recognize the real value of health coverage that an employer provides to its nonhighly compensated employees.

Also, all health coverage, whether core or noncore that meets the general nondiscrimination provisions of this bill, should be permitted to be taken into account in measuring the 133-percent cap. Furthermore, we believe the cap should be set at 150 percent rather than 133 percent.

As concerns flexible benefit plans, as we see it the bill is likely to subject to tax most, if not all, of the salary reduction contributions of many highly compensated employees under flexible benefit plans. In our view, this is unfair treatment ot salary reduction contributions by these employees. Further the bill might disrupt many existing flexible benefit plans and discourage the formation of new ones.

Flexible benefit plans have allowed employers to continue to provide greater health coverage to their employees and allow employees to share the cost of these plans on a reasonable basis. These plans have helped employers controls costs while maintaining meaningful health benefit plans for employees.

However, the bill, which would treat salary reduction contributions and employer provided credits for nonhighly compensated employees as employee provided contributions, and in the case of highly compensated employees would treat these monies as employer provided benefits will certainly discourage the formation of flexible benefit plans, and likely hurt the continuance of the existing plans.

This, in turn, is likely to result in a significant reduction of the amount of health care coverage provided by employers to employees.

We recommend that salary reduction contributions and employer provided credits under flexible benefit plans be treated equally for all employees. To do otherwise would be inequitable and counterproductive.

Finally, many employers have already spent considerable amount of time, energy, and money in building systems, compiling data and running tests to meet the current section 89 rules. The bill, in recognition of these good faith efforts by these employers should be amended to permit employers to choose either the current section 89 rules or the new section 89 rules for purposes of satisfying the nondiscrimination criteria after 1989. We note that the bill already allows this choice for 1989.

In conclusion, the existing section 89 rules have certainly created a costly nightmare for employers. Buck welcomes the attempt to simplify the rules. However, we urge that the Ways and Means Committee make the changes noted above in order to make these rules more livable for employers.

Thank you.

[The statement of Frederick W. Rumack follows:]

Statement of Frederick W. Rumack, on Behalf of Buck Consultants, Inc.

Good Morning. I am Frederick W. Rumack, the Director of Tax and Legal Services for Buck Consultants, Inc., one of the nation's leading employee benefits consulting firms. As a benefits consultant to numerous large and mid-size employers, Buck has witnessed numerous problems in assisting employers in applying the current Section 89 rules and, thus, is in a position to analyze and evaluate the impact of H.R. 1864 on employer-sponsored health plans. From our vantage point, attempting to comply with the existing Section 89 rules has been very costly for many of our clients. The costs to some of our clients have run into the hundreds of thousands of dollars.

First, let me begin by congratulating Chairman Rostenkowski for recognizing Section 89 for the costly administrative nightmare that it is and trying to rectify the situation by introducing legislation to simplify the Section 89 rules.

However, there are a number of areas in this bill that should be changed.

Delay of Effective Date of Section 89

Before I turn to specific provisions in H.R. 1864, I would like to first suggest that the effective date of Section 89 should be delayed, at the very least, until January 1, 1990 or until regulations under the new rules are issued, if later. There is mass confusion among plan sponsors concerning the future direction of Section 89 and many employers have now taken a wait-and-see attitude because of this uncertainty. Even under the current Section 89 rules, there is still not sufficient guidance for employers to comply fully. Furthermore, any changes to Section 89 are not likely to be enacted until the fall.

Thus, a delay would grant employers time to react to and comply with new Section 89 rules. In addition, a delay would prevent needless additional expenditures by employers in complying with the current rules that are likely to be revamped by Congress and give the IRS time to provide the needed guidance.

General Description of H.R. 1864

H.R. 1864 would replace the current Section 89 nondiscrimination rules applicable to statutory employee benefit plans -- that is, generally accident or health plans and group term life insurance plans. The new rules would contain a 90% availability test and an affordability test, both of which are applicable to nonhighly-compensated employees, and a general nondiscrimination provision that would apply to accident or health plans. If these tests are met, then the employer-provided accident or health benefits provided to highly-compensated employees would generally be tax favored up to a 133% limit. If these tests are not met, then the total value of employer-provided accident or health benefits for highly-compensated employees would be fully taxable.

Indexing of Employee Contributions

For purposes of determining what health plans may be considered available to the nonhighly-compensated employees in meeting the 90% availability test, the bill limits mandatory employee contributions for qualified core coverage by nonhighly-compensated employees to $10.00 a week for single coverage and $25.00 a week for employee and family coverage. These limits would be indexed to increases in the national average of wages.

Buck believes that the indexing of these employee contribution limits should be directly related to increases in health care costs for employers. These costs for employers generally have increased and are projected to increase at a much higher rate than the national average of wages.

Buck's actuaries currently project a trend factor for employer health care costs of 15% to 20% while the national average of wages is unlikely to increase at more than 6% to 7% a year (the national average of wages increased at a compounded annual rate of 6.54% from 1977 to 1987). We believe an index could be developed to measure these increases in employer health costs. This index should be used to determine increases in the $10.00 and $25.00 employee contribution limits.

If the national average of wages is used as an index -- rather than a more representative index -- the net result over time will be a dramatic increase in employer health care costs as compared to employee costs. This is likely to result in significant reductions in the amount of health care coverage provided by employers to both active and retired employees.

Separate Testing for Certain Employees

In meeting the 90% availability test, it would greatly ease employers' testing burdens if employees with less than six months of service could be tested separately -- particularly for industries with high employee turnover.

Also, the rules should allow employers to exclude from testing altogether collectively bargained employees covered by multiemployer plans because of the difficulty in getting the appropriate data. Furthermore, employers should have the option of testing collectively bargained employees who are not in multiemployer plans separately or by including them with nonunion employees.

Cap on Tax-Favored Benefits for Highly-Compensated Employees

Another issue concerns the calculation of the 133% cap on tax-favored benefits for highly-compensated employees. The requirement that the lowest value plan among the best available plans for any nonhighly-compensated employee within the 90% group would be the value to be multiplied by 133% simply serves to reduce unjustifiably the overall level of benefits that may be provided to highly-compensated employees on a tax-favored basis. Instead of using the lowest value plan as a base, we suggest that the average value of core plans available to nonhighly-compensated employees be used as the base for calculating the 133% cap. This would recognize the real value of health coverage that an employer provides to its nonhighly-compensated employees.

Also, all health benefits -- whether core or noncore -- that meet the general nondiscrimination provision should be permitted to be taken into account in measuring the 133% cap. Furthermore, this cap should be set at 150% rather than 133%.

Section 125 Cafeteria Plans -- Salary Reduction Contributions

H.R. 1864 is likely to subject to tax most, if not all, of the salary reduction contributions of many highly-compensated employees. In our view, this is unfair treatment of salary reduction contributions by highly-compensated employees as opposed to the treatment of salary reduction contributions by nonhighly-compensated employees. Furthermore, H.R. 1864 might disrupt many existing flexible benefit plans.

Flexible benefit plans (including employer-provided credits and salary reductions) have allowed employers to continue to provide greater health coverage to their employees and allow employees to share the cost of these plans on a reasonable basis. These plans have helped employers control costs while maintaining meaningful health plans for employees.

However, the H.R. 1864 provision which treats salary reduction contributions and employer-provided credits for nonhighly-compensated employees as employee-provided contributions and, in the case of highly-compensated employees, treats these monies as employer-provided contributions will discourage the formation of flexible benefit plans and possibly even hurt the continuance of existing plans. This, in turn, is likely to result in significant reductions in the amount of health care coverage provided to employees.

We suggest that salary reduction contributions and employer-provided credits be treated equally for all employees. To do otherwise, would be inequitable and counterproductive.

Employer Choice

Finally, many employers have already spent a considerable amount of time and costs in building systems, compiling data and running tests to meet the current Section 89 nondiscrimination rules. H.R. 1864, in recognition of these good faith efforts by many employers, should be amended to permit employers to choose either the current Section 89 rules or the Section 89 rules under this bill for purposes of satisfying the nondiscrimination criteria after 1989.

Conclusion

The existing Section 89 rules have created nightmarish problems for employers. Buck welcomes attempts to simplify the Section 89 rules.

H.R. 1864 offers much-needed simplification but several provisions in this bill, in its present form, would create problems for employers and would be counterproductive. We urge the Ways and Means Committee to make the changes noted above to this bill.

Chairman ROSTENKOWSKI. Thank you, Mr. Rumack.

Are there any questions of this panel?

Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

I would just like to thank this particular panel. Collectively, you have summarized the complaints that I've personally received from the business community back in my home State and what made me a zealot in terms of trying to find some corrective action.

I have just jotted down some things where it appears that all of you are in agreement. I would like to just see if my notes are correct.

It appears that all of you feel the index presently contained in H.R. 1864 should be changed to better test the inflation that is truly reflected in the health care industry.

Are all of you in agreement there?

Mr. RUMACK. Correct.

Mr. ANTHONY. All of you are in agreement that there should be some delay in implementation in order to give both the tax practitioners and the business community reasonable opportunity to comply with what could be the third change since 1986? Is that a fair statement?

Mr. RUMACK. Yes.

Mr. ANTHONY. Mr. Kushner, you indicate that you might have some problem there.

Mr. KUSHNER. Well, the association that I am here representing today still fully supports repeal of section 89 in its entirety.

Mr. ANTHONY. I know. But you said repeal.

Now, the chairman said he is against repeal. Although he might be willing to amend H.R. 1864. So let's talk about that.

Assuming you don't get repeal, what about delay on implementation? Do you think that would be rational

Mr. KUSHNER. I would concur with that recommendation.

Mr. RAUP. Excuse me. I would like to add to that, that a great many of small business people in our area assume that you all are going to repeal because so many people signed on to LaFalce's repeal bill.

Mr. ANTHONY. Yes. Well, they are not keeping up with the real set of politics. I would encourage you to correct their thinking.

Mr. RAUP. Well, we would certainly give that a great deal of effort but, unfortunately, our local press back home does not always help us in that endeavor.

Mr. ANTHONY. Well, the chairman is helping you along in that regard, I can promise you that. [Laughter.] But I also would like to add my congratulations to the chairman for being willing to introduce the bill and would hopefully make some of the changes that you have recommended.

But, as I also understand your testimony, you think that H.R. 1864 should not be the total end of all ends. It should be an alternative to solve some of the existing problems. You have got some companies that are already presently complying with the current law who have paid the money to get their plans in shape. I have constituents tell me they had paid upward of $10,000 to pay consultants to comply.

Yet, they would be out of compliance possibly with 1864. That certainly would be an unequitable situation.

So did I hear you consistently say it should be applied as an alternative in these type of situations?

Mr. **Rumack**. Yes.

Mr. **Kushner**. Yes.

Mr. **Anthony**. Mr. Raup, do you agree?

Mr. **Raup**. Yes.

Mr. **Anthony**. And then, last, it appears that all of you agree that section 125, cafeteria plant, should not be disallowed by the rewrite of H.R. 1864. Is that correct?

Mr. **Rumack**. That's correct.

Mr. **Raup**. Yes.

Mr. **Kushner**. Yes.

Mr. **Anthony**. Well, I asked a question yesterday, and what I have ascertained is that there is one company that's presently in compliance that would be out of compliance, yet they provide benefits to their low paid employees as equal as they do to their high paid employees.

Well, I would hope that the committee wouldn't make another mistake in trying to correct the mistake. So I think your testimony has been very valuable to the record. And I thank you for your efforts.

And, Mr. Chairman, I yield back.

Mr. **Jenkins**. Mr. Chairman.

Chairman **Rostenkowski**. Mr. Jenkins.

Mr. **Jenkins**. Mr. Chairman, I have some questions.

On the $10 and $25 a week cap, in looking at the group rates, particularly for groups of 50 employees or below, I have been checking some of the rates, and I want to know if this is a real problem. I know that you are for indexing at a realistic rate.

But does the $10 and $25 threshold or cap cause us any real problems?

Mr. **Kushner**. If I could address that, in a couple of ways, under the existing proposal, it would. The fact that in a flexible benefit plan that those amounts that an employee could use in taking a lesser health plan such as, if you will, cashable credits, count toward that $10 or $25, and the effect that that would have, it would cause quite a bit of problem to employers of all sizes that have adopted true cafeteria plans.

Second, even if that problem were to be solved today, the $10 and $25 index today where many employers, medium to large-size employers, may be OK, smaller employers may have greater difficulty in meeting the threshold. And with the currently proposed indexing proposal, it wouldn't be very long until they were up against that cap.

The problem that would then be proposed to those employers is that one of the solutions would be to scale back their health care plans in order to bring the contributions within the index limits.

So, that at the time that the employees could least afford to make contributions, their costs and their coverages would be coming down.

Mr. **Jenkins**. Well, when you refer to the small employers that would have problems, did they typically require the employee to contribute a certain percentage under most health plans?

Mr. **Raup**. I'll take a stab at that, if you don't mind.

We have done a lot of work with small employers. Most of them do have the employees contributing toward their health coverage. And while no one is like another, more often than not, small employers have had their employees pay for the dependent coverage. They may provide their employees the full cost of employee coverage. But if they want dependent coverage, they will pay the full freight for that additional cost.

Mr. **Jenkins**. Well, if we have the $10 and $25, is that, in effect, going to eliminate the dependent coverage?

Mr. **Raup**. I think it would certainly go an awfully long way of eliminating it for the small employers. But one of the questions that we make in our technical remarks and did not comment orally, is when you look at a plan that qualifies for single coverage, is it disqualified for single coverage if you can't meet it on the family side?

There was some intent by the regulations when they were issued for the original section 89 that those plans would be treated separately, a single plan was separate from a dependent plan. If that's the same, then there is some chance for that situation that you're talking about, you may lose some dependent coverages, but at least the plan will still be in compliance on the single side. If the whole thing goes out the window, I am not sure where we are going to end up.

Mr. **Jenkins**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman. Just a brief question, if any of you would like to respond.

I am considering offering, if we mark up a bill, to change section 89, with a small business exemption.

We, in almost every instance, minimum wage, parental leave, and other areas, develop small business exemptions for good reasons for mom and pop stores that might employ 12 people, 9 full and 3 part time.

You know, they don't have accountants and the ability to deal with the kind of regulations and complexities that we confront them with. And there are no exceptions or exemptions in section 89. I am proposing that we consider a basic small business exemption.

I have decided the threshold, maybe 50 employees or less.

Any responses to that?

Mr. **Nicholas**. I would like to respond to that.

I think any type of an exemption on that basis is going to be biased toward the larger employers, they are going to have to pick up that larger share of the tax burden that is not going to be collected from the small ones.

I think that the premise that maybe the committee makes that is so outrageously expensive for small businesses to comply with is erroneous. There are lots of many, many consulting firms providing very, very good counsel to small businesses at very, very affordable rates, not at Mr. LaFalce says, $60,000 a year to test a 50-man firm. I find that rather ludicrous and misleading.

Mr. **Dorgan**. I personally have yet to discover a reason we place consulting firm——

Mr. **Nicholas**. We have seen a lot of companies similar to ours, not just ours, there are many of them throughout the United States offering testing services for under $1,000 for 30, 40, 50 employees, which is amounting to 1 or 2 percent of their total cost for health care in a year.

Mr. **Dorgan**. Any other observations that I would care more to hear?

I appreciate your point, I mean, but my point is you have got a lot of businesses out there that are hanging on by their fingertips. The last thing they want to do is be turned into full-time bookkeepers in dozens of areas. And for that reason, in many areas of public policy, there have been granted small business exceptions.

Any observations from other members of the panel?

Mr. **Raup**. Yes. Certainly the small business people would like to be exempted. We do some work for them. We also do administrative work for school districts. They like to be exempted. Municipalities would like to be exempted. And once you start down that list of who should be exempted, we may create another set of rules that will be tough to deal with.

If the rule itself in how we deal with employee benefits can be put together simply enough for all parties, we shouldn't need exemption. If it gets so complex that we have to exempt certain people, maybe we need to reevaluate the rule itself.

Mr. **Dorgan**. I might want to withdraw my question here. [Laughter.]

I appreciate your contribution. Yes, sir?

Mr. **Nicholas**. May I ask a question?

Have there been any insurance companies here that have made any testimony to have any of this repealed or to make any amendments?

Mr. **Dorgan**. I have to defer to the chairman.

Mr. **Nicholas**. Have there been any insurance companies that have testified before the committee, or that have given input to the committee on why section 89 should be repealed? And do you have any reasons to——

Mr. **Jenkins** [presiding]. The Chair is not knowledgeable.

Mr. **McGrath**. Would the gentleman yield on that?

Mr. **Jenkins**. I'll be happy to yield.

Mr. **McGrath**. Generally the insurance company, the providers of benefits have been trying to work within the system to overhaul section 89 rather than repeal it?

Mr. **Nicholas**. Well, my point in asking that question frankly is that I think the insurance companies, to some extent, and the people that run large trusts, look to these laws in enforcing many of the provisions that they have assumed have been enforced in their contracts for years.

But they will see better underwriting more people that are properly in their programs. And much of the abuse is from the small employer that doesn't get the professional counsel to, in fact, do things properly. That's why you probably haven't seen too many of them here.

Mr. McGrath. Well, I guess a response to that might be that it's a product they have to sell and they want to sell it. Well, I'll get to you when my own time comes up.

Mr. Jenkins. Mr. McGrath.

Mr. McGrath. Thank you, Mr. Chairman.

Let me ask an overall question. One of the arguments we hear about section 89 is that if it becomes too complex, people are just going to drop their plans. And the intention of the committee to provide health insurance to employees would be mitigated.

Let me ask you this on a realistic basis. Given the fact that unemployment rates are coming down, we are looking toward a deficit of employees in the nineties.

How realistic is it to believe that employers would drop plans when we know that they are going to recruit and maintain and retain employees in the nineties?

Mr. Kushner. If I can address that. As a consultant, we have worked with a number of especially small- to medium-size companies. And, unfortunately, section 89 did not occur in a vacuum. It hit at exactly the time that health care costs and health care insurance programs were eating at employers, where they were seeing 30, 40, 50. In one case we had a client—we got a client after they got a 184 percent increase from their carrier. And, on top of that, now comes section 89 as it currently exists, with its complex administrative burdens. And it is in essence becoming the straw that broke the camel's back.

We have had a number of clients that our firm has seen, and I am aware of other smaller employers that, with the burdens of the health care cost increases and section 89, are indeed dropping their plans. The issue is not one of recruiting and retaining for the 1990's. The issue is one of remaining in business in 1989.

Mr. McGrath. Well, as somebody who was involved in the design of the fix here, one of the problems that we heard from small businesses, in particular, were the data collection problems. And we went to a design-based plan to fix that to some extent.

We heard generally about the applicability of a 17½-hour employee being included in the 90/50 test, and we changed that to some extent.

We heard about leased employees being counted as employees and, with a certification, we fixed that to some extent.

With the former employees, we have fixed that to some extent by making it prospective.

How far further should we go here in fixing the problems of small business?

Mr. Nicholas. Mr. McGrath.

Mr. McGrath. Yes.

Mr. Nicholas. We have seen no employers who are going to drop their health care programs because of this. I think what we are going to see is a whole lot of people are just not going to obey this law. They feel that the time that they are going to get caught is when the Internal Revenue Service comes around and they will take their chances.

That's what we have seen is the most common reaction to small employers that say it is too tedious.

As far as the data collection, I think that H.R. 1864 goes a long way in reducing the data collection. I think that probably the single greatest thing that it does is change the part-time rules, and that is something we have heard a great deal of concern about throughout the country.

Mr. McGrath. Mr. Raup, you responded, as well as others, to Mr. Dorgan's question, that there ought to be no exemptions.

We have heard others say there ought to be an exemption for multiemployer plans because of the complexity of finding out how the union employees are used in various multiemployer functions, even per day.

I used the example yesterday of a dockworker in New York who might work for three different companies on the same day.

Absent an exemption for multiemployer plans, do you have any good way that we could test multiemployer plans?

Mr. Raup. In talking about there shouldn't be exemptions, I was referring to specific industries. I think especially the multiemployer plans present very unique problems in any testing. They have always been run, as one of the earlier persons testified, from the trustees as the plan. And I think to look beyond that and try to make either the employee or the employer individually responsible for what is happening is terribly difficult.

Mr. McGrath. We understand that. But once we exempt them, you were absolutely correct in saying that there are going to be a lot of 501(c)(3)s in for exemption. Municipal and local governments are going to be coming in saying that they should be exempted.

Where do we stop when it comes to exemptions? Should we exempt anybody?

Mr. Raup. It is a difficult question. I don't know that I can give you any hard answers on that.

We do note in our testimony that some consideration may help when you redefine what a separate line of business is, especially in the public arena. You may have a county that has four or five different benefit plans out there because, when you look at the employees' cover they are receiving benefits from various tax revenues. And it is almost like you have four or five employers covering——

Mr. McGrath. Would the fix that we put in for municipalities that allows for separate testing for each collective bargaining unit within a municipal government be somewhat helpful in handling the multiemployer test?

Mr. Raup. It may—I'm sorry, it may help. But I would like to go on record of stating that many of these employer groups and municipalities bargain with their employee groups even though they are not officially collectively bargained. They may go through the same process even though it is not an official union representation.

Mr. McGrath. Obviously my time has expired.

Mr. Jenkins. As a matter of fact, it went over slightly.

Mrs. Johnson.

Mrs. Johnson. Thank you very much.

I appreciate the panel being very specific in your comments. I want to pursue this issue of exceptions a little further.

Would it significantly simplify the process of compliance, and do you see any equity problems with simply excluding collectively bargained employees? Because it is very difficult for Government to know, what the bargaining agreement was, what was given up in order to get what.

And I have trouble with, in a sense, mandating benefits or mandating the structure of benefit plans on top of a collective-bargaining process. So I am interested in whether you think it would significantly simplify the compliance matters for business if employees covered by union agreements were excluded, if collectively bargained Government employees were excluded, and if you see any equity problems with that?

Mr. KUSHNER. If I could address that, section 89, and now H.R. 1864 are swings of the pendulum to two extremes.

In section 89, collectively bargained plans were, by definition, included in testing. Under H.R. 1864, the pendulum is swung to the other side, and they would be specifically excluded from testing. And I think perhaps a middle position would be more appropriate where the employer could, in doing their testing, elect to either include or exclude their collectively bargained plans for the very reason that you stated, that in some cases the employees and the bargaining units have given up something else, or have taken benefits, and ended up either with a very high or perhaps a very low benefit plan based upon their own structure and their own needs. And you could end up in a very inequitable position either in certain cases including or, in other cases, excluding collectively bargained plans entirely where the rules are that strict.

And my belief would be that the most fair solution would be to allow that on an elective basis, employer by employer.

Mrs. JOHNSON. Anyone else differ with that opinion?

One other question to follow up on an earlier line of questioning. Do you think the $10/$25 definition in this bill is satisfactory? I mean do most employees currently pay $10 or less, $25 or less? What do we do by defining this in dollar terms rather than percent of salary terms?

Mr. RAUP. Maybe we should consider another one, and that is a percent of the cost of the benefit. Because what is driving the cost of providing health care, which is the greatest portion of the benefit cost, has nothing to do with the salary or the employer or the employee. It is the prices being charged by the providers.

Mrs. JOHNSON. Would you say that was a better measure?

Mr. RAUP. It may be, I think, one that is more practical to live by, because each group will play by its own set of rules.

Mrs. JOHNSON. Do you have any idea what $10 and $25 would translate into in terms of percent of the cost of benefits?

Mr. RAUP. It is going to vary by plan and by area of the country.

Mrs. JOHNSON. But, by choosing $10 and $25, I mean one problem sitting here is to figure out what does that mean? What does that mean to the majority of people with benefits? Does that cover the majority? How close to the margin are we? Are most employees already paying $10 so it would mean there would be no room for increase? What percentage of benefit costs now is it?

Mr. RAUP. I'll speak only for central Ohio since I know that market area. And I think you will find that $25 a week represents about 50 percent of the dependent cost in our area, and between 40 and 50 percent of the single cost.

Now, that is on a generalized plan. And that is going to vary. I gave an example earlier of a rate increase that we got of 54 percent. Well, if that happens, you immediately make your cost 25 percent of the total, not 50.

Mr. KUSHNER. I would like to expand on that as well in that the definition of the $10 and $25 for flexible benefit plans. In the case of virtually all cafeteria plans or salary reduction plans, those employees will be over the $10 and $25 limits just by definition. And it seems that there is some inequity in that flexplans merely change the delivery system of benefits; that a $25,000-a-year employee with $5,000 worth of fixed benefits should be somehow treated differently than a $30,000 a year employee who can elect to spend $5,000 of that salary on the same exact benefits, there should not be a differentiation in treatment between those two employees.

Mr. NICHOLAS. I think any time that you have a fixed dollar amount like that, you are going to have problems. You are going to have problems with geographic differences between one community and another. You are going to have differences in terms of the employer's ability to negotiate with an insurance carrier. Larger firms certainly have a lot more negotiating power than 5- and 10-man groups. You are going to have problems when insurance carriers, as they are right now, raise their rates rather erratically, and you have to move from one carrier to another, or when they are dropping out and you have to take interim coverage.

For those reasons, we are proposing, and the administrators that we came to represent feel that some of the older rules under section 89 may be more fair, and they would like an opportunity to qualify under that basis right there, as well as an opportunity to qualify under the new proposed H.R. 1864 regulations.

Mrs. JOHNSON. Thank you. My time has expired.

Mr. JENKINS. Are there any further questions?

Mr. Anthony.

Mr. ANTHONY. If you would allow me, I would just like to follow-up on some of Mrs. Johnson's inquiry. And I'm glad that you mentioned regional differences and also the competitive nature between a small company and a large company because there is just no question that the marketplace is kinder to somebody that's got a thousand employees than somebody that's got a hundred employees.

What I am looking for, though, is some way to put pressure on the health industry to lower their costs. In other words, how do we get them to slow down their rate of increases?

Is there anything that you could devise that you could recommend to this committee that we could place in section 89 that would tend to have a cost push down? Because, as I understand the policy behind 1864, it would be that once you have exceeded the $10 and the $25, Mrs. Johnson, is that what the employer will do would be to turn to the employee and say you now have to go to a higher deductible or you have to go to a higher copay rather than shifting it to the premium.

So that would be the response of getting it to the employee rather than on the premium side. And that is the problem you are going to run into when you put it on a fixed dollar cost.

But is there any way that you gentlemen could help us try to devise a formula that would put the pressure on the provider so that we could shift some of this cost to the providers and not to the employer or the employee?

Mr. McGRATH. Would the gentleman yield on that?

Mr. ANTHONY. Yes, I'd be happy to.

Mr. McGRATH. I think, you know, we've heard a lot of testimony on making it a percentage of the health care costs to the employers. But I think you've hit the nail on the head when you say, that by doing that, we are creating a cost-plus situation, as we have in Medicare and other reimbursement methodologies and therefore there would be no incentive for companies' providers to hold their costs down and be competitive throughout the Nation.

Mr. ANTHONY. So what bothers me is, to some extent, about the nondiscrimination rules is that we are encouraging employers to provide more health coverage. That's the stated goal of section 89 through nondiscrimination policies is not only to provide coverage to the president, to the vice president, but provide coverage to the secretaries and the janitors in the small and larger companies.

Well, that is really helping the doctors and the hospitals and the outpatient providers because it is giving them more business through a tax policy. So, at the same time, how can we devise, and maybe section 89 is not the proper place to do it, maybe a better place to do it is under some other form of health legislation. But I am just curious. Can you devise a beginning place in section 89.

Mr. Raup.

Mr. RAUP. Outside of rationing health care, there is, while you all are sitting here pondering these issues, 50 other States who are out there having their own deliberations and passing more and more mandated benefits. So, that as you walk from State to State, you now have over 700 different mandated benefits that insurance companies and plans who have multistate locations have to put up with.

In the State of Ohio, they are considering mandating coverage for in vitro fertilization, which is a very, very expensive procedure. Well, if they do that, and we are also left with this cap of $10 and $25, we have cost pushed that coverage even higher.

It may be that we need to look at some exemption as ERISA provided for the State mandated benefits as they relate to many of the insured plans. You know, that's one of many things to look at.

We have, when we define health care, and we have begun to define health care not as basic levels of benefits but as catastrophic major medical coverages, a real problem because there is no incentive for the employee not to seek treatment or to seek cost effective treatment. There is no incentive for the provider to look at the cost of spending either your money, through Medicare or Medicaid, or our employer's money through our plans in any way.

Mr. ANTHONY. My time is about to expire. If, when you get back in the calm of your own office and have time to think about it, if you come up with any suggestions, if you could, just submit them either to me directly or submit them to the chairman for insertion in the record. I think it would be beneficial.

Thank you.

Mr. JENKINS. The committee expresses its appreciation to the panel for your testimony. Thank you very much.

The next panel, Peggy Gann, Manville Corp.; Gerald Facciani, American Society of Pension Actuaries; and Victor Gilla. Each of your prepared statements will be made part of the record. You may summarize. Ms. Gann.

STATEMENT OF PEGGY GANN, MANAGER OF EMPLOYEE BENEFITS, MANVILLE CORP., DENVER, CO, ON BEHALF OF THE CAFETERIA PLAN COALITION

Ms. GANN. Thank you, Mr. Chairman, for the opportunity to appear before your committee today concerning H.R. 1864. My name is Peggy Gann. I am presently the manager of employee benefits for Manville Corp.

My company is a Fortune 500 business with operations in forest and paper products, fiber glass, and filtration and mining, employing approximately 13,000 people in over 20 States; including Georgia, Arkansas, and Texas.

Manville is proud to be a member of the rapidly growing group of companies sponsoring cafeteria plans. More importantly, I am very excited about being here today because, as you can see, I am not a CEO or a vice president or even a director of a large corporation. I am an employee.

Second, and perhaps most importantly, I am a working mother who is the primary source of benefits for her family. For 20 years, I worked at our Waukegan plant just north of Chicago. Many of those years were spent as the insurance lady, representing the benefit issues for the employees to the company and to the carriers.

So I hope I come today with a little different perspective than some of the other people who have testified.

About 3 years ago, the company invited me to join the corporate benefits group and since then, as you know, health care costs have skyrocketed and we are not sure where it is going to end. During that time, I have been working with a group of people, trying to design a responsible benefit program for our employees.

Today I am appearing on behalf of the Cafeteria Plan Coalition, an ad hoc group of over 100 members representing a broad spectrum of the work force, ranging from city governments to universities to small and large employers to cafeteria plan designers. We are here today, Mr. Chairman, because we believe your bill clearly is a step in the right direction of simplifying section 89.

However, at the same time, we believe the bill needs technical changes to avoid significant problems for cafeteria plans. Without these technical modifications, most cafeteria plans which currently satisfy nondiscrimination rules under both Internal Revenue Code section 89 and 125 would fail H.R. 1864. We believe this is clearly an unintended result of your well-intentioned bill.

Before I discuss our specific views on H.R. 1864 and its impact on cafeteria plans, I would like to tell you why Manville supports the concept of cafeteria plans. As I indicated 2 years ago, or 3, we began considering ways to redesign our employee benefit program. We decided upon a cafeteria plan for two primary reasons.

First, a cafeteria plan gives participants the freedom of choice to design a benefit program that best suits their own individual needs. We find this to be particularly important in light of the changing demographics of the American work force. There are many instances in which employees are single parents or are in situations where both spouses work.

Second, a cafeteria plan can control overall health expenses. By requiring the employees to make decisions regarding the level and cost of their coverages, we believe that they will be better health care consumers which will result in more cost-conscious utilization of health care.

Yesterday, during the hearings, I heard Representative Rostenkowski acknowledge the health care crisis facing America, and rightly stated that Government employers and employees must sit down together and address this problem. In essence, the cafeteria plan gives that forum.

Employers address cost containment through design and define contribution. Employees choose appropriate levels of coverage for their individual needs. Section 125 governs tax and nondiscrimination issues.

Mr. Anthony brought up the other part that seems to be missing in all of our concerns, and that is the providers. I guess three out of four is a good start, though.

Manville's cafeteria plan was specifically designed to pass the current section 89 nondiscrimination rules, as well as the additional nondiscrimination rules that cafeteria plans must pass under section 125. Cafeteria plans like our own have shown that they can easily pass the stringent requirements of current section 89 as well as more equitably distribute benefit dollars to all employees.

In spite of this, our plan would fail the nondiscrimination rules in H.R. 1864. Consequently, we may now have to reexamine whether to implement the plan scheduled to go into effect January 1, 1990. We have already invested hundreds of thousands of dollars and substantial amounts of time in designing the plan.

We have suggested, in our written statement, technical solutions to the problems faced by the cafeteria plans under the bill. These changes would have the effect of eliminating the most important problems the bill represents for cafeteria plans.

The Cafeteria Plan Coalition encourages the committee to modify H.R. 1864 in line with our recommendations, so that these innovative benefit programs may continue to be offered to our employees.

Last, let me say from my perspective, that legislating the demise of cafeteria plans is not in the best interest of working mothers, single parents, child care, or cost containment in general.

On behalf of the coalition, I would be pleased to respond to any questions the committee members may have or work with its staff and the committee itself, in explaining or exploring how cafeteria plans really do meet the objectives set forth by section 89.

Thank you.

[The statement of Peggy Gann follows:]

Statement of Peggy Gann, Manville Corp., on Behalf of the Cafeteria Plan Coalition

Thank you, Mr. Chairman, for the opportunity to appear before your Committee today concerning H.R. 1864, section 89 simplification legislation. My name is Peggy Gann. I am responsible for Employee Benefits for Manville Corporation. My company is a Fortune 500 business with operations in forest and paper products, fiber glass, and, filtration and mining, employing approximately 13,000 people in over 20 states. Manville is proud to be a member of the rapidly growing group of companies that sponsor cafeteria plans. I am personally pleased to have had the opportunity to design and set up Manville's cafeteria benefit plan.

Today, I am appearing on behalf of the Cafeteria Plan Coalition, an ad hoc group of over 100 members representing a broad spectrum of the workforce, ranging from city governments to universities to small and large employers to cafeteria plan designers. We are here before you today, Mr. Chairman, because we believe your bill clearly is a step in the right direction of simplifying section 89. However, at the same time we believe the bill needs technical changes to avoid significant problems for cafeteria plans. Without these technical modifications most cafeteria plans, which currently satisfy nondiscrimination rules under both sections 89 and 125 would fail H.R. 1864. We believe this is clearly an unintended result of your well intentioned bill.

Before I discuss our specific views on H.R. 1864, and its impact on cafeteria plans, I would like to tell you why Manville is interested in the concept of cafeteria plans, which are also known as flexible benefits programs. Two years ago we began considering ways to redesign our employee benefits program. We decided upon a cafeteria plan for three primary reasons:

First, a cafeteria plan gives participants the freedom of choice to design a benefits program that best suits their own individual needs. We find this to be particularly important in light of the changing demographics of the American workforce. Today there are many instances in which employees are single parents or are in situations where both spouses work. Manville's cafeteria plan will enable our employees to choose the employee benefits that are most appropriate for their individual circumstances.

Second, a cafeteria plan can control overall health expenses. By requiring that employees make decisions regarding the level and cost of their coverages, we believe that they will be better health care consumers which will result in more cost-conscious utilization of health care.

Finally, a cafeteria plan enables the employer to shift a reasonable share of the ever increasing costs of health care coverage to employees, while at the same time enabling the employees to absorb these costs through salary reduction. The need to share health care expenses is especially important for businesses competing in domestic and international markets.

Manville's cafeteria plan was specifically designed to pass the current section 89 nondiscrimination rules as well as the additional nondiscrimination rules that cafeteria plans must pass under section 125. Cafeteria plans like our own have shown that they can easily pass the stringent requirements of current section 89. In spite of this, our plan would fail the nondiscrimination rules in H.R. 1864. Consequently, we may now have to re-examine whether to implement the plan scheduled to go into effect January 1, 1990. We have already invested hundreds of thousands of dollars and substantial amounts of time in designing the plan.

Even so, the Coalition supports the general concept of simplification behind H.R. 1864. We believe, however, that the bill has the unintended effect of disqualifying cafeteria plans that are nondiscriminatory under current sections 89 and 125. As you know, the bill requires that an "affordable core health plan" be available to 90 percent of the nonhighly compensated employees of the employer. In addition, it limits tax free benefits by highly compensated employees to 133% of the employer's contribution for nonhighly compensated employees to the core health plan.

A major problem under the bill for our cafeteria plan, and any cafeteria plan for that matter, is the way in which H.R. 1864 defines the employee's contribution. As one might expect, after-tax contributions by employees are counted in testing whether coverage is affordable. However, the bill goes further in requiring that "cashable credits" the employer gives to an employee to either elect coverage or--if the employee doesn't need coverage--to take as taxable cash, must be counted as employee contributions. The same appears to be true for "tradeable credits" that an employee would not cash out but may use to elect non-health coverage, such as dependent care. Finally, salary reduction amounts are also treated as employee contributions in determining whether a plan is affordable.

Employer credits are at the very heart of cafeteria plans since they are the vehicle that gives the employee freedom to choose what is best for him or her. Because of the way H.R. 1864 treats employer's credits and salary reduction, a cafeteria plan is highly likely to exceed the $10 and $25 affordability limits. As a result, the entire plan would be deemed discriminatory even though its coverage of low paid employees may be much better than under many plans that pass H.R. 1864. Under the bill it wouldn't matter that a cafeteria plan has enough credits for all employees to purchase coverage--the plan will fail just because employees are given the choice of how to allocate employer credits.

In addition, the bill provides that in applying the 133% figure to highly compensated benefits, salary reduction is treated as an employee contribution by highly compensated employees. Let me give you an example:

Assume that an employer contributes $1,000 toward the cost of health coverage under an affordable core health plan and the employee contributes $520 through salary reduction. In that case, the maximum amount of employer provided benefits a highly compensated employee could receive without being taxed is $1333--that is the employer's $1,000 contribution times 133 percent. Because the $520 salary reduction by highly compensated employees is considered an employer contribution, the total employer provided benefit received by the highly compensated employees would be $1520. Since this is above the $1333 figure, the highly compensated employees would receive $187 in additional taxable income. This would happen even though highly compensated and nonhighly compensated employees elected exactly the same benefits.

The Coalition believes that H.R. 1864 is clearly a step in the right direction as far as section 89 simplification is concerned. At the same time, it is equally clear that the bill presents enormous problems for cafeteria plans -- even those plans that would pass muster under the difficult current law tests.

To help alleviate these problems, we need a workable availability test for cafeteria plans to allow design-based compliance. In order to permit availability-based testing under H.R. 1864 for cafeteria plans, we suggest the following three changes.

First, cashable or tradeable credits should be treated as employer contributions for purposes of determining whether a plan is affordable, and for purposes of applying the 133 percent limitation on higher-paid employees' benefits. After all, these credits do represent dollars the employer contributes to the plan to allow employees to select the coverage options that are best for them. Both employees and employers recognize these credits as employer contributions. For example, they are not included as part of employee earnings in determining compensation-related benefits, such as life and disability insurance or pension and profit sharing benefits. Treating credits as what they are -- employer money -- would prevent cafeteria plans with credits from automatically becoming discriminatory simply because the employees can allocate these employer contributions to best suit their needs.

Second, as the Joint Committee Staff Description of H.R. 1864 notes, salary reduction amounts should be treated as employee contributions for purposes of the affordability limits, because such amounts do constitute a cost to employees. These salary reduction amounts, however, also have tax-benefits attached to them. As such they are properly included when determining the tax-favored amount of benefits received by both nonhighly compensated and highly compensated employees for purposes of the 133 percent test. In determining the amount of tax-favored benefits for the nonhighly compensated, however, the Coalition believes that only affordable salary reduction amounts (i.e., salary reduction amounts that, when combined with after-tax employee contributions, meet the $10 and $25 limits) should be included. This prevents employers from making the unreasonable claim that nonhighly compensated employees have unlimited amounts of salary reduction available to them when applying the 133 percent test.

Third, the 133 percent test should compare the average benefits of highly compensated employees to the average affordable benefits available to the nonhighly compensated employees. This would allow one-time-per-year testing, which would be easier for all employers. In addition, it allows a disparity between highly compensated and nonhighly compensated employees that is more in line with that permitted under current section 89 -- which limits average benefits for highly compensated employees to 133-1/3 percent of the average benefits for nonhighly compensated employees. This approach would also avoid the following anomalous results:

- If an employer with 100 nonhighly compensated employees provides 85 of those employees with benefits valued at $1000 per year and the other 15 with benefits valued at $100 per year, under H.R. 1864 the base value for application of the 133 percent rule would be $100, because that is the maximum employer-provided value received by 90 percent of the nonhighly compensated employees. Thus, under H.R. 1864 the highly compensated employees could only exclude premiums of $133 from their income. Therefore, if the 10 highly compensated employees received the same $1000 benefit as most of the nonhighly compensated employees, they would, nonetheless, be taxed on $867. In contrast, if the 133 percent rule was applied to the average benefit received by nonhighly compensated employees, the base would be $950 (85 x $1000 plus 5 x $100 divided by 90) and the highly compensated employees would be taxed only on $50.

- Also, under H.R. 1864 highly compensated employees that need greater than average benefits (e.g., older employees, or employees in poor health) will typically end up being taxed -- even when average benefits for the highly compensated are in line with average benefits for the nonhighly compensated. Looking at benefits for the entire group avoids penalizing employees with greater benefit needs. This is a particular concern for cafeteria plans -- because cafeteria plans are designed to expand employee choices, the differences between amounts of benefits chosen can be greater than under many traditional plans. The test should look at the overall result.

In addition to a workable availability test, employers also need a simplified coverage test because many plans, including some cafeteria plans, simply will not match the design tests' specific requirements, but will have excellent relative coverage for nonhighly compensated and highly compensated employees. It would be anomalous if a plan that actually provided clearly nondiscriminatory coverage failed the section 89 tests because its design did not fit the exact mold that H.R. 1864 permits. Being able to test based on design is clearly a major step forward, but we should not require employers to restructure thousands of nondiscriminatory plans by making it the exclusive test.

Finally, H.R. 1864 eliminates the right to test for dependent care assistance plans under section 89, which results in application of the often much more stringent nondiscrimination requirements of section 129. These rules are much more elaborate than the nondiscrimination rules applicable to life insurance under the bill. In our view, one of the major steps forward under H.R. 1864 is the realization that benefits like group-term life insurance are not properly tested under rules designed for health insurance. We suggest that the same is true for dependent care assistance as well. Just like life insurance, dependent care assistance should be tested under an updated version of prior nondiscrimination standards.

These changes would have the effect of eliminating the most important problems the bill presents for cafeteria plans. I have personally spent hundreds of hours trying to find the best and most progressive employee benefit program for our employees. I genuinely believe that cafeteria plans make the most sense in light of the changing demographics of our workforce. The Cafeteria Plan Coalition encourages the Committee to modify H.R. 1864 in line with our recommendations so that these innovative benefit programs may continue to be offered to employees.

On behalf of the Coalition, I would be pleased to respond to any questions the Committee Members might have.

Mr. JENKINS. Thank you, Ms. Gann. Mr. Gilla.

STATEMENT OF VICTOR GILLA, MEMBER, BOARD OF DIRECTORS, EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION, AND CORPORATE MANAGER OF EMPLOYEE BENEFITS, BALL CORP., MUNCIE, IN

Mr. GILLA. Thank you, Mr. Chairman.

My name is Victor Gill and I am the corporate manager of employee benefits for Ball Corp. in Muncie, IN. Today I represent the Employers Council on Flexible Compensation, of which I am a director. ECFC is a nonprofit group comprised of 350 member organizations which represent over 10 million American workers. Our members include business corporations, hospitals and clinics, universities, State and local governments. Our council members provide elective benefits, such as cafeteria flexible benefit plans, for their employees.

As a sponsor of a cafeteria plan, I speak on behalf of the thousands of employers who provide their employees with the most innovative and flexible employee benefit arrangements. Cafeteria plans, sometimes called flexible benefit plans, offer employees a choice in the design of their benefit program. Employees are not bound by the decisions made by management. Instead, each individual may tailor his or her benefits to his or her own specific needs. And as those needs change in subsequent years, the employee may change the benefit election.

Cafeteria plans offer the following advantages for both employees and employers. First, as I have indicated, cafeteria plans allow employees to choose what is best for them rather than having benefits imposed upon them. According to a 1987 ECFC survey, which I have attached to the record, 97 percent of the women and 64 percent of the men participating in flexible benefit arrangements expressed reluctance to return to their previous system of imposed benefits. These people realize that today's most needed benefits can best be delivered through cafeteria plans. Cafeteria plans allow two-wage families to avoid the redundant costs of two medical plans. That in itself is a major factor in the appeal of cafeteria plans. Dollars that would have been wasted on duplicate coverage are channeled toward other, needed benefits. These benefits, in a majority of companies, include child care.

Second, employers can introduce a degree of health care cost containment through flexible benefits. Typically, the employer will allocate to each employee an amount comparable to the employers' cost for providing benefits under the former, imposed structure. The employee gets to choose where to spend that money and which benefit to take.

Employees who take more expensive medical coverage, for example, may not have as many dollars left over to purchase optional coverage such as vision or dental care. Some employees choose less expensive coverage and take the remaining amount in cash in their paychecks, paying taxes as they do on any salary or wages.

Third, employers are being asked by Congress, by this administration, and public policy planners to shoulder a larger load in delivering new and innovative benefits. These would include proposals before this Congress to make the offering of child care and other dependent care available in every cafeteria plan. Elder care, funding for the postretirement medical costs, and funding for housing, all of these are areas for which the public policy planners and legislators see cafeteria plans as a logical answer.

But we have a problem, and that is section 89.

You are to be congratulated, Mr. Chairman, for the tremendous progress that H.R. 1864 makes in simplifying section 89. In March, ECFC conveyed to you our belief that discrimination tests based upon plan design rather than testing participation would resolve many of the major problems. The design-based tests in your proposal do resolve a substantial number of problems.

But the proposal raises, perhaps inadvertently, new problems for cafeteria plans which could result in cafeteria plans being unable to accommodate the array of choice-making now permitted. This might end the possibility of flex being used as the delivery system for future innovative benefits.

Two facts are important. First, cafeteria plans are not a separate benefit in the conventional sense. Cafeteria plans are merely delivery systems for benefits. A multitude of benefits are delivered to employees through the conduit of cafeteria plan. The tax status of any benefit delivered through a cafeteria plan is not changed simply because it is delivered through a flexible benefit plan and not under a conventional system.

Second, employers who sponsor cafeteria plans have become accustomed to the more sophisticated data collection and records keeping because such records are required to implement the choices made by various employees under cafeteria plans.

Take Ball for instance. We would pass most of the current section 89 tests, but we have a good deal of trouble in meeting the life insurance test. But we are absolutely convinced that, in our cafeteria plans we have provided flexible, responsive, and fair benefits to all employees.

H.R. 1864 would impose a tax on benefits delivered through a cafeteria plan, but not impose a tax on those same benefits when provided outside a cafeteria plan. If this committee believes that revenue must be raised through the taxation of employee benefits, would it not be better to confront the issue head on? Should we not consider that the socially desirable and utilitarian value of cafeteria plans, as well as the broad acceptance by participants and employers could be negated? This would mean that the current revenue needs could cripple our future ability to provide innovative benefit and compensation programs to American workers.

Let me move quickly to some recommendations that I have here. Employers provide credits or dollars that represent the employer cost of providing benefits. These credits or dollars are then allocated as the employee wishes. Employer credit dollars that an employee can take in cash should not be treated as employee contributions under the affordability limits of the eligibility test in H.R. 1864.

I believe, Mr. Chairman, according to the light, I am out of time.

[The statement of Victor Gilla follows:]

ecfc **Employers Council on Flexible Compensation**
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TESTIMONY REGARDING H.R. 1864
EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION
COMMITTEE ON WAYS AND MEANS
MAY 3, 1989

My name is Victor Gilla and I am Corporate Manager of Employee Benefits for the Ball Corporation of Muncie, Indiana. Today, I represent the Employers Council on Flexible Compensation, of which I am a director. ECFC is a non-profit group comprised of over 350 member organizations which represent over 10 million American workers. Our members include business corporations, hospitals and clinics, universities, and of state and local governments. Council members provide elective benefits, such as cafeteria flexible benefit plans, for their employees.

As a sponsor of a cafeteria plan, I speak on behalf of thousands of employers who provide their employees with the most innovative and flexible employee benefit arrangements. Cafeteria plans, sometimes called flexible benefit plans, offer employees a choice in the design of their benefit program. Employees are not bound by decisions made by management. Instead, each individual may tailor his or her benefits to his or her specific needs. And as those needs change in subsequent years, the employee may change the benefit program to match his or her new circumstances.

Cafeteria plans offer the following advantages for employees and employers:

First, as I have indicated, cafeteria plans allow employees to choose what is best for them rather than having benefits imposed upon them. According to a 1987 ECFC survey, which I have attached for the record, 97% of women and 84% of men participating in a flexible benefits arrangement expressed reluctance to return to their previous system of imposed benefits. Those people realize that today's most needed benefits can best be delivered through cafeteria plans. And cafeteria plans allow two-wage families to avoid the redundant costs of two medical plans. That in itself is a major factor in the appeal of cafeteria plans. Dollars that would be wasted on duplicate coverage can be channelled toward other, needed benefits. These benefits, in a majority of companies, include child care.

Secondly, employers can introduce a degree of health care cost containment through flexible benefits. Typically, the employer allocates to each employee an amount comparable to the employers' cost for providing benefits under the former, imposed structure. The employee gets to choose where to spend that money - which benefit to take. Employees who take more expensive medical coverage, for example, may not have as many dollars left over to purchase optional coverage such as vision care or dental insurance. Some employees choose less expensive coverage and take the remaining amount in cash in their paychecks, paying taxes as they do on any salary or wages.

Thirdly, employers are being asked by Congress, the Administration and public policy planners to shoulder a larger load in delivering new and innovative benefits. These would include proposals before this Congress to make the offering of child care and other dependent care available in every cafeteria plan. Elder care, funding for post-retirement medical costs, and funding for housing - all of these are the areas for which public policy planners and legislators see cafeteria plans as the logical answer.

Yet, we face a problem: Section 89.

Mr. Chairman, you are to be congratulated for the tremendous progress that H.R.1864 makes in simplifying Section 89. In March, ECFC conveyed to you our belief that discrimination tests based upon plan design rather than testing participation would resolve many of the major problems. The design-based tests in your proposal do resolve a substantial number of problems. But the proposal raises, perhaps inadvertently, new problems for cafeteria plans which could result in cafeteria plans being unable to accommodate the array of choice-making now permitted. This might end the possibility of flex being used as the delivery system for future innovative benefits.

Two facts are important. First, cafeteria plans are not a separate benefit plan in the conventional sense. Cafeteria plans are merely delivery systems for benefits. A multitude of benefits are delivered to employees through the conduit of the cafeteria plan. The tax status of any benefit delivered through a cafeteria plan is not changed simply because it is delivered through a flexible benefits plan and not under a conventional benefit system.

Secondly, employers who sponsor cafeteria plans have become accustomed to more sophisticated data collection and records-keeping because such records are required to implement the choices made by various employees. Therefore, cafeteria plan sponsors did not have as much difficulty as some other employers in gathering data and conducting tests under the current Section 89. Section 125, the part of the tax code creating cafeteria plans, has for years imposed discrimination tests upon cafeteria plans. Therefore, most cafeteria plans of which ECFC is aware passed the majority of the current Section 89 rules. Others would pass with relatively minor adjustments. But just the reverse is true under H.R.1864.

Take Ball Corporation as an example. We pass most of the tests in current Section 89. We have trouble with group life insurance. H.R.1864 would eliminate that difficulty, but create more problems elsewhere. We are absolutely convinced that we have progressive, responsive and fair benefits for all employees. If you examine our plans, I think you will agree. But we join hundreds of cafeteria plan sponsors in having troubles with Section 89. Most cafeteria plans, including many that have already passed current Section 89, would fail the tests in the new proposal.

H.R.1864 would impose a tax on benefits delivered through a cafeteria plan, but not impose a tax on those same benefits when provided outside a cafeteria plan. If this Committee believes that revenue must be raised through the taxation of employee benefits, would it not be better to confront that issue head-on? Shouldn't we consider that the socially desirable and utilitarian value of cafeteria plans, as well as the broad acceptance by participants and employers, could be negated? This would mean that current revenue needs could cripple our future ability to provide innovative benefit and compensation programs for American workers.

> For example, an employer offers a health plan covering all its employees. Until 1990, the employer paid all the premiums ($2,500 for employee only coverage and $5,000 for family coverage). In 1990, the employer adopts a cafeteria plan and allows employees who demonstrate that they have other medical coverage (e.g., under a spouse's plan) to elect to receive $600 in cash for employee-only coverage or $1,400 in cash for family coverage. If H.R.1864 were adopted in its present form, this plan would result in every highly compensated employee having to include the value of the coverage he or she selects in taxable income (i.e., $5,000 where family coverage is selected or $2,500 where employee only coverage is selected). This result is caused solely because of the employer's decision to permit employees to choose cash instead of coverage. Without the choice, there would be no income inclusion for highly compensated employees.

Recommendations

We have some recommendations that could correct the problems and would place cafeteria plans on a level playing field with other benefit delivery methods.

Employers provide "credits" or "dollars" that represent the employer cost of providing benefits. These credits or dollars are then allocated as the employee wishes. Employer credit dollars that an employee can take in cash should not be treated as employee contributions under the affordability limits of the eligibility test of H.R.1864.

The "eligibility test" requires that affordable core coverage be available to 90 percent of an employer's lower-paid employees. To be affordable, the employee's share of the premiums must not exceed $10 per week for employee-only coverage and $25 per week for employee-and-family coverage. The employee's share includes not only after-tax contributions, but pre-tax salary reduction. Salary reduction presumably includes "cashable credits" - - credits provided by the employer that the employee may use to select benefits or take in taxable cash. The coverage may not be regarded as "affordable" and the cafeteria plan may be required to treat an amount equal to the taxable benefits as the employee's share of the premium. Because an employee may elect to take cash, and pay taxes, any cash taken should not affect the eligibility test.

If the rule distinguishes between cashable employer credits and salary reduction contributions for purposes of the affordability test, however, staff is concerned that employers might attempt to evade the affordability test by reducing employees' salaries across the board and then increasing the cashable credits under the cafeteria plan. In fact, that is unlikely to happen. Employers would face an employee relations crisis if they arbitrarily reduced pay by enough to make the difference. Cash in the paycheck is the first concern of the vast majority of workers. Typically, when an employer first offers a cafeteria plan, each employee is offered credit to purchase benefits. The employer, as a practical matter, could not convince employees to participate, if the plan required across-the-board salary cutbacks. The element of salary reduction is voluntary on the employee's part.

We suggest a simpler solution. The following conditions would prevent employers from manipulating cashable credits to evade the tests:

> Cashable employer credits could be treated as employer money and not as employee contributions where the employee who opts down to a catastrophic level of coverage, or who drops out of coverage altogether, must first demonstrate that he has other core coverage. With the number of families with dual wage earners, the attraction of cafeteria plans to these employees is obvious -- if an employee receives medical coverage through a spouse's plan, there is no need to have duplicative coverage.

Conditioning the treatment of cashable credits as employer contributions on proof of other coverage does not require the kind of complicated sworn statement rules that are contained in the original Section 89. A much smaller group of employees will have to be asked about the other coverage and the scope of the statement will be far less intrusive. An employee would not be asked whether he has a family or dependents, but merely whether he has coverage elsewhere. Also, since the cash benefit payment is contingent upon the showing of other coverage, the employee is not likely to be upset about having to provide the information. This is not the case with the current Section 89 rules where the employer needs to obtain personal information from low-paid employees and where is no potential benefit to these employees.

Employers were rightfully concerned about how burdensome the original Section 89 "sworn statements" requirement was. We are cautious, therefore, in suggesting this approach. We do believe, however, that an employee with a financial interest will be much more inclined to sign a statement regarding coverage as a condition of receiving cash.

Another alternative would be to treat cashable employer credits as employer money rather than employee money where the cash-outs do not occur pro-rata through the year as salary payments would, but where the cash-outs occur only at the end of the year. An employer will not reduce employees' pay by 10% across the board and then give the money back to employees in the form of cashable credits if the employees will receive the cashable credits only at the end of the year.

If the "cashable credit" problem is resolved, we can move on to the treatment of real salary reduction under the bill. The proposal counts salary reduction contributions as part of the employer-provided benefit for purposes of the 1.33 cap on highly-paid employees, but does not count the salary reduction contributions as part of the value of the core plan that is used to calculate the value of the cap for the highly-paid. The rules should be applied consistently. We recommend that affordable levels of salary reduction be counted toward the value of the core plan.

Salary reduction, as defined in the Internal Revenue Code, includes any money or credit that an employee can choose to receive in cash. For example, if an employee chooses to use $1000 of his/her company credit for medical coverage, this amount would be considered as salary reduction because the employee could have taken it in cash.

As we understand the proposal, H.R.1864 would include salary reduction amounts to determine the employer provided benefit value of highly-paid employees, but would not include salary reduction to determine the value of benefits for non-highly paid people.

This could result in all of the benefits under a plan being taxable to highly compensated employees even though the plan provides identical benefits to all employees. Example:

- A company offers a cafeteria (flexible benefits) plan to all its employees. The plan includes health care options; the most valuable is worth $3,000.

- All employees are given $3,000 as a company credit, which can be used for health care options, or cash.

This plan would fail the tests outlines in H.R.1864. The value of the employer provided benefit would be zero for non-highly-paid employees, because salary reduction amounts are not included in this calculation. Highly-paid employees would be taxed on the entire amount of their health care benefit, even though they receive benefits identical to those offered non-highly paid employees.

Finally, to avoid having to revisit the affordability limits, it might be better to base it on a percentage of the employee's contributions to the total cost of the plan rather than on flat dollar amounts. Alternatively, the flat dollar amounts could be indexed to a medical cost index rather than to a wage index.

Mr. Chairman, we at ECFC appreciate your leadership in the effort to simplify Section 89. We will work with you and the staff to accomplish the objective to prevent bias toward the highly paid in tax favored employee benefits. But accomplishing that objective should not require that this nation's most innovative benefits-delivery vehicle suffer. We, as employers, as employees, and as a nation need the flexibility and savings that cafeteria plans offer. Thank you for this opportunity to share our concerns.

ecfc

EMPLOYEE ATTITUDE SURVEY ON FLEXIBLE COMPENSATION
March, 1987

Employers Council on Flexible Compensation

1. Do you participate in the flexible compensation plan that is currently offered by your employer?

YES	76	
NO	7	(Terminated)
DON'T KNOW	17	(Terminated)

2. Have you participated in a flexible compensation plan for more than one year?

	YES	NO	DON'T KNOW
% Male	88	9	3
%Female	90	7	3
Total	89	8	3

3. Do you prefer the flexible compensation plan over the other benefit systems where you had fewer choices?

	YES	NO	DON'T KNOW
% Male	80	7	13
%Female	91	1	8
Total	85.5	4	10.5

4. Do you feel that your personal benefits coverage has improved, remained unchanged or suffered under the flexible compensation plan?

	IMPROVED	UNCHANGED	SUFFERED	DON'T KNOW
% Male	51	21	12	16
%Female	57	25	7	11
Total	54	23	9	14

5. Do you feel that your employer does a good job of explaining your choices and helping you to understand the flexible compensation plan?

	YES	NO	DON'T KNOW
% Male	60	32	8
%Female	69	30	1
Total	65	31	4

6. If your employer returned to your former benefits plan without flexible compensation, would you pleased, displeased or unconcerned?

	PLEASED	DISPLEASED	UNCONCERNED	DON'T KNOW
% Male	23	64	12	1
%Female	2	97	1	0
Total	12.5	81	6	0.5

7. Which of the following reasons do you feel influenced your employer to adopt a flexible compensation plan?

	AGREE	DISAGREE	DON'T KNOW
Desire to be competitive with other employers	72	18	10
Desire to provide improved benefits	77	12	11
Desire to save employer money	50	44	6
Desire to save employee money	28	61	11

8. If you were to consider taking a position with another employer, but found that the new employer did not offer a flexible compensation plan, would that have any influence on your decision?

	STRONG INFLUENCE TO STAY	SOME INFLUENCE TO STAY	NO INFLUENCE	DON'T KNOW
% Male	23	38	30	9
% Female	59	28	10	4
Total	41	33	20	6

9. If you were looking for another job and all other things were equal, would you be more impressed with an employer who offered a flexible compensation plan?

	YES	DEPENDS	NO	DON'T KNOW
% Male	26	50	22	2
%Female	56	28	10	6
Total	41	39	16	4

10. If your employer did not offer a flexible compensation plan, and you were offered a position at the same salary level with an employer who had a flexible compensation plan, would you be more likely to accept the new job?

	YES	DEPENDS	NO	DON'T KNOW
% Male	2	16	75	7
%Female	28	33	25	14
Total	15	25	50	10

11. Does the fact that your employer offers a flexible compensation plan cause you to think more or less highly of your employer?

	MORE HIGHLY	DOESN'T MATTER	LESS HIGHLY	DON'T KNOW
% Male	23	69	0	8
%Female	51	41	2	6
Total	37	55	1	7

Please respond to each of the following statements as they apply to your experience with flexible compensation plans.

12. I am able to avoid duplicating coverage with my spouse.

	YES	NO	DON'T KNOW
% Male	15	82	3
%Female	61	32	7
Total	38	57	5

13. I can get benefits that are not available with most employers.

	YES	NO	DON'T KNOW
% Male	19	65	16
%Female	70	25	5
Total	45	45	10

14. I can select benefits to meet my specific needs.

	YES	NO	DON'T KNOW
% Male	62	37	1
%Female	66	31	3
Total	64	34	2

15. I can get more benefits.

	YES	NO	DON'T KNOW
% Male	20	61	19
%Female	24	64	12
Total	22	63	15

16. I can increase the size of my paycheck by trading benefits.

	YES	NO	DON'T KNOW
% Male	13	27	60
%Female	10	35	55
Total	11	31	58

17. I do not see any advantage.

	YES	NO	DON'T KNOW
% Male	2	76	22
%Female	4	87	9
Total	3	82	15

Mr. JENKINS. Thank you, Mr. Gilla. Mr. Facciani.

STATEMENT OF GERALD D. FACCIANI, CHIEF EXECUTIVE OFFICER, FACCIANI & CO., CLEVELAND, OH, AND MEMBER, GOVERNMENT AFFAIRS COMMITTEE, AMERICAN SOCIETY OF PENSION ACTUARIES

Mr. FACCIANI. My name is Gerald Facciani. I am CEO and 100-percent owner of Facciani & Co., the largest independent actuarial consulting firm in the State of Ohio. I have extensive personal experience with section 89.

I appreciate the opportunity to appear today, and I am representing the American Society of Pension Actuaries, whose 2,700 members provide actuarial, administrative, and consulting services to several hundred thousand employee benefits plans, primarily sponsored by small business.

I want to state at the outset that we applaud the introduction of H.R. 1864. The bill represents significant improvement to the existing section 89 by substituting design based discrimination testing for data based discrimination testing. Simply put, if we have to choose between this bill and that with which we have been wrestling, we would clearly choose H.R. 1864.

We believe that significant relief will be provided by many aspects of this bill, such as the elimination of requiring sworn statements; the redefinition of part-time employees; and the exclusion of life insurance from the section 89 nondiscrimination rules. However, we believe there are aspects of the bill which could be changed or clarified, without adversely affecting the intent of section 89, and therefore we recommend the following:

With regard to qualification standards, these are important because plan provisions need to be understood by covered employees. However, with regard to such standards, we believe there should be some safe harbor for small employers in the area of written documents and employee notifications. The determination of small employer could follow the requirement of the annual reporting form for the form 5500, that is, small employers could be ones with plans covering fewer than 100 participants.

Such small employers could be allowed to rely on the documentation and employee booklets provided by the insurance company or HMO for any plan that is fully insured.

With regard to geographical differences in employee contribution limits, we suggest that the $10 and $25 limits might be modified to represent a percentage of the single or family coverage premium in a given locale. These limitations could be indexed to reflect differing prevailing wage rates in different sections of the country.

H.R. 1864 would index the $10 and $25 weekly contribution maximums to increases in Social Security wages. While the concept of continued affordability is laudable, tying increases in these levels to wage increases, rather than health care inflation increases, will have the effect—especially in small businesses—of decreasing the availability of coverage for nonhighly compensated employees.

Our written testimony presents some numerical illustrations of this concept.

Many small employers will simply not be able to absorb these increases. Sadly, the long-term effect may be to force small employers into dropping their coverage altogether. H.R. 1864 should be modified to set the cost of living adjustment provided to an appropriate health care related index, rather than Social Security wage increases.

We would hope that the definition of a health plan could be tightened to clarify that accidental death and dismemberment insurance and business travel accident insurance are not health plans.

With regard to testing union employees, H.R. 1864 requires employers to test their union employees separately from their other employees. For employers struggling with testing multiemployer union plans, the ability to test separately will represent major relief from the current law.

However, H.R. 1864 should be modified to allow employers to test their union employees with their other employees if desired. Many small employers have designed full benefit packages that include the union's benefits, particularly in single employer collectively bargained settings. Such packages logically should be tested as a whole.

There appear to be several areas where language in the statute does not comport with examples in the introduction. Proper clarification in the final draft will be essential to a correct understanding of H.R. 1864.

One final issue did not come to light until very recently when we obtained a copy of the description of the bill prepared by the staff of the Joint Committee on Taxation. This description appears to conflict with the bill in several respects and particularly in at least one very meaningful way. It seems to bring back the 50-percent eligibility test of existing section 89. This is inconsistent with the purpose of simplifying section 89 testing.

We urge that this 50-percent provision be considered in the context of simplification and be dropped.

On behalf of the American Society of Pension Actuaries, and Facciani & Co., I appreciate the opportunity to testify before you today; and on behalf of the hundreds of thousands of small employers represented by our membership, we look forward to the relief this bill provides.

Thank you.

[The statement of Gerald D. Facciani follows:]

Statement of the American Society of Pension Actuaries

on

H. R. 1864

Relating to Simplification of Section 89

Nondiscrimination Rules

for

May 3, 1989

Hearing Before the Committee on Ways and Means

Witness: Gerald D. Facciani
Member, Government Affairs Committee

I appreciate the opportunity to appear today. I am representing the American Society of Pension Actuaries (ASPA), whose 2,700 members provide actuarial, administrative, and consulting services to several hundred thousand employee benefit plans. I would add that I am the CEO of Facciani & Company, the largest independent consulting firm in Ohio. I have extensive personal experience with Section 89.

I want to state at the outset that we applaud Congressman Rostenkowski for introducing H.R. 1864. The bill represents a significant improvement to the existing Section 89 by substituting design based discrimination testing for data based discrimination testing. While there are certain specific aspects of the bill which we feel should be changed, we believe the bill fundamentally goes in the right direction. Simply put, if we have to choose between H. R. 1864 and that with which we have been wrestling, we would choose H. R. 1864.

As previously indicated, the approach of Section 89 in substituting design based testing for data based testing is a sound one. We also believe that significant additional relief will be provided by other aspects of H.R. 1864, such as the elimination of requiring sworn statements; the redefinition of part-time employees; and the exclusion of life insurance from the Section 89 nondiscrimination rules. However, we believe there are aspects of the Bill which should be changed or clarified, and we recommend the following:

QUALIFICATION STANDARDS

Qualification standards are important because plan provisions need to be understood by covered employees. Nevertheless, large and, particularly, small employers will continue to be burdened with compliance in the area of qualification standards. We firmly believe that the legally enforceable, exclusive benefit and permanency provisions of the qualification standards are fair and necessary. However, small employers do not have the resources to deal with the documentation portions of the standards.

We believe there should be some safe harbor for small employers in the area of written documents and employee notifications. The determination of "small employer" should follow the requirements of the annual reporting for Form 5500; that is, small employers are ones with plans covering fewer than 100 participants.

Such small employers should be allowed to rely on the documentation and employee booklets provided by the insurance company (or HMO) for any plan that is fully insured.

GEOGRAPHICAL DIFFERENCES IN EMPLOYEE CONTRIBUTION LIMITS

The concept of making health coverage affordable is vital. Limitations on employee contributions clearly should be retained, but the specific limitations proposed are unrealistically low. We suggest that the $10 and $25 limits might be modified to represent a percentage of the single or family coverage premium. Furthermore, the applicable limits are more significant in some parts of the country than others. These limitations should be indexed to reflect differing prevailing wage rates in different sections of the country.

DEMOGRAPHIC, GEOGRAPHICAL, AND UTILIZATION ADJUSTMENTS

Under existing Section 89, certain adjustments are permissible in determining employer provided benefit costs. These include adjustments to eliminate differences in cost attributable to demographic, geographical, and utilization differences.

Respecting demographic and geographical differences, existing Section 89 permits adjustments for purposes of applying the tests, but not for purposes of calculating taxable income when the tests are failed.

It should be made clear in H.R. 1864 that these adjustments are permissible for purposes of applying the Benefits Test. To do otherwise could, for example, subject the older highly compensated employee to taxation even where the schedule of benefits is the same for everyone.

WEEKLY CONTRIBUTIONS INDEXED IN RELATION TO WAGES

Additionally, H. R. 1864 will index the $10 and $25 weekly contribution maximums to increases in Social Security Wages. While the concept of continued affordability is laudable, tying increases in these levels to wage increases rather than health care inflation increases will have the effect, especially in small businesses, of decreasing the availability of coverage for non-highly compensated employees.

The following example demonstrates our concerns:

Current plan premium - $20 per week
Employee's share - $10 per week
Employer's share - $10 per week

Year 1 inflation
  Premium increase - +25%
  SS wage increase - + 4%

  New plan premium - $25 per week
  Employee's share - $10.40 per week
  Employer's share - $14.60 per week

Year 2 inflation
  Premium increase - +25%
  SS wage increase - + 4%

  New plan premium - $31.25 per week
  Employee's share - $10.82 per week
  Employer's share - $20.43 per week

After just two years, the employer has experienced a 104.3% increase in its health care costs (from $10 per week to $20.43 per week).

Many small employers will not be able to absorb these increases. Sadly, the long-term effect will be to force small employers into dropping their coverage altogether. H. R. 1864 should be modified to set the cost-of-living adjustment provided in (c)(3) to an appropriate health care-related index rather than Social Security wage increases.

TAXABLE INCOME AS A DEDUCTIBLE MEDICAL EXPENSE

It should be clarified that any employer cost taxable under the rules of the Benefits Test is a medical expense potentially deductible by the participant under Section 213.

DEFINITION OF HEALTH PLAN

The definition of a health plan should be tightened to clarify that accidental death and dismemberment insurance and business travel accident insurance are not health plans.

TREATMENT OF FAMILY AGGREGATION FOR CERTAIN HIGHLY COMPENSATED EMPLOYEES

This treatment is governed by Code Section 414(q)(6). To illustrate, consider a small corporate business owned and operated by father and son. Suppose a uniform health plan is available to all employees (including father and son) at no charge to employees. Because of 414(q)(6), father and son must be treated as one individual. This one hypothetical individual has health coverage worth twice as much as the coverage of any other employee.

It would be impossible to find an arrangement for the provision of health coverage more egalitarian than the one we recite. Yet when existing 414(q)(6) is combined with the new Bill, it appears under the Bill that father and son will be taxed on a third of their health care protection.

There is a different and more rational approach to family member aggregation in Code Section 401(a)(17). There, family members are restricted to spouses and lineal descendants under age 19. We believe two definitions of family are one too many. We believe the definition in 401(a)(17) places the focus where it belongs: on the immediate family unit. We urge that 414(q)(6) be amended to incorporate the same definition as 401(a)(17).

FAMILY COVERAGE

The wording of the proposed bill might imply that, for the purposes of the 90% eligibility test, "qualified core coverage" mandates some form of required employer-provided benefit for family-only coverage. Smaller employers have historically provided employer-subsidized coverage for their employees but not for employees' families. We propose section 89(c)(2)(B) be clarified as follows:

> "(B) such health plan does not require contributions by the employee in excess of $10 per week for employee-only coverage ($25 per week in the case of a plan with some amount of employer-provided family coverage.)"

UNION EMPLOYEES TESTED SEPARATELY FROM OTHER EMPLOYEES

H. R. 1864 requires employers to test their union employees separately from their other employees. For employers struggling with testing multi-employer union plans, the ability to test separately will represent major relief from the current law.

However, H. R. 1864 should be modified to allow employers to test their union employees with their other employees if desired. Many employers have designed full benefit packages that include the union's benefits, and such package logically should be tested as a whole.

CORE VS. NONCORE COVERAGE IN THE 133% BENEFITS TEST

The 133% benefits test, detailed in the proposed 89(b)(2), works quite well for plans with core coverage only. It is, indeed, a fine method of determining the value of discriminatory core benefits received by highly compensated employees. The theory is marvelously simple--any benefit received by a highly compensated employee in excess of 133% of that available to non-highly compensated employees is taxable to the highly compensated. The formulas, however, do not work quite so well for plans with noncore coverage on top of the core coverage.

The mechanics of the formulas will produce taxable income for highly compensated employees even in the case of plans which do not discriminate in practice.

We do not propose reverting to testing techniques based upon the actual coverage received by employees as required by current law. Instead, we propose that core coverage and noncore coverage be required to be aggregated. The aggregated plan should not be subject to the "qualified core" plan rules (i.e., primarily core and costing employees less than $10/$25 per week) for purposes of the 133% test. The total employer-provided benefit available to the non-highly compensated should be compared to the employer-provided benefit received by the highly compensated. Salary reduction contributions should be counted as an employer-provided benefit for both the benefit received by the highly compensated and the benefit available to the non-highly compensated. Excesses over the 133% threshold should again be taxable to the highly compensated employees.

EFFECTIVE DATE

Small business owners, particularly, are, at best, confused by Section 89. Establishing an effective date of the first plan year after enactment of the "new" Section 89 would provide much needed relief to this sector.

CONFORMING THE LANGUAGE IN THE STATUTE TO THE EXAMPLES IN THE INTRODUCTION

There are several areas where language does not comport with examples. For example, in the **Introduction to H. R. 1864**, there are three qualified core health care plans with respective values of $500, $1,000, and $1,500. The HCEs are able to get a deduction equal to 133% of $1,500. This is the correct conclusion because if the employer is offering these plans to 90% of the staff with the $10 and $25 limitation then clearly it is the employee's choice to pick a lower value plan. The language of the proposed statute would lead one to believe that the exclusion would be equal to 133% of $500.

FIFTY PERCENT ELIGIBILITY TEST

Our final issue did not come to light until very recently when we obtained a copy of the description of the Bill prepared by the staff of the Joint Committee on Taxation (JCS-9-89, April 25, 1989).

This description conflicts with the Bill in several respects and particularly in at least one very meaningful way. IT SEEMS TO BRING BACK THE 50 PERCENT ELIGIBILITY TEST OF EXISTING SECTION 89, and this is inconsistent with the purpose of simplifying Section 89 testing. We urge that this 50% provision be considered in the context of simplification and be dropped.

On behalf of the American Society of Pension Actuaries, I appreciate the opportunity to testify before you today, and on behalf of the hundreds of thousands of small employers represented by our membership, we look forward to the relief this Bill provides.

Again, I want to thank you for the opportunity to testify, and applaud the effort to bring much needed relief from Section 89.

Mr. JENKINS. Thank you, Mr. Facciani. Are there questions from the committee? Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman. I welcome the entire panel, but a special welcome to Ms. Gann. You acknowledged that you have a plant in Arkansas. That plant happens to be located in my home county. The plant is one of the largest employers in that particular region.

I think the point that you make, and also the other two members of the panel, in terms of not doing away with cafeteria plans is good testimony and it would fly in the face of other legislative initiatives that are presently ongoing in the Congress.

It would appear to me that if we take a backward step and say to working women in the work force, and especially single family parents who very much depend upon child care, that we take out of the Tax Code and rewrite section 89, their ability to utilize cafeteria plans for child care and other dependent care services, while at the same time we have had reported out of Education and Labor Committee a child care and parental leave legislation to encourage or even mandate that employers provide voluntary free time only protecting the job, would just be contradictory in terms of public policy.

I think your testimony clearly illustrates that and I thank you for it. And a special welcome to the committee, Ms. Gann.

Ms. GANN. Thank you.

Mr. ANTHONY. Mr. Gilla, your time ran out and you had a recommendation that you were going to make, and I have read a statement here that says employer credit dollars that an employee can take in cash should not be treated as employee contributions as the affordability limits of the eligibility tests of H.R. 1864. I just wondered if you could expand on that a little bit.

Mr. GILLA. That has to do with the calculation of the value of the plan that we could give to a highly compensated employee versus what we could do to the nonhighly compensated employee. There was a couple of other statements in here that some of the staff members were under the impression that if we fooled around with taking either employee dollars as either cash or benefits that companies might make an attempt to reduce salaries to account for that.

I was about to say that it would be extremely difficult for employers to go about reducing salaries to account for dollars that they are already putting on the table in the form of benefits.

The intent of the testimony was to ask the committee to treat the credits or dollars that employers put on the table in flexible benefits plans consistently between the highly compensated and the nonhighly compensated employees. In both of those cases, they are treated as employer dollars, and that was the intent of the testimony.

Mr. ANTHONY. Thank you for that clarification. I yield back, Mr. Chairman.

Mr. JENKINS. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

First and foremost, let me say that I do not believe there is any sentiment, nor was it the intent of the committee to discriminate against cafeteria plans that provide flexible benefit plans. Any provisions that do this, will be addressed during the markup.

Mr. Facciani, you testified that there are some inconsistencies between first, what is in the preamble and the text of the bill and second, what is in the bill and the Joint Committee pamphlet. Could you enumerate some of those?

Mr. **Facciani**. Surely. Specifically, on page 9 of our written testimony, which I did not want to read into the record because it would have necessitated the arrival of the red light, there is a section there which simply laid out a mathematical calculation which appears to us to be erroneous. I suspect it was simply a mistake that happened in the drafting, just overlooked. Not a big deal, but enough to cause a little confusion among those of us who suffer some trepidation when we see line items where numbers are a little bit different.

For the record, in the introduction to H.R. 1864, there are three qualified core health care plans with respect to values of $500, $1,000, and $1,500. The highly compensated employees are able to get a deduction equal to 133 percent of $1,500. This is the correct conclusion because if the employer is offering these plans to 90 percent of the staff with the $10 and $25 limitation, then clearly it is the employee's choice to pick a lower value plan. The language of the proposed statute would lead one to believe that the exclusion would be equal to 133 percent of $500. That is the first one.

With regard to the last issue, the 50-percent eligibility test, upon review of the description of the bill prepared by the staff of the Joint Committee on Taxation, the description was dated April 25 and came out a little bit later than the floor description and the bill itself.

I indicated that the description appears to conflict with the bill in several respects and that it seems to bring back the 50-percent eligibility test of existing section 89.

I had a little trouble reading that section in the Joint Committee on Taxation draft and if, in fact, that is the case—and I am not saying it is, I am saying I had difficulty reading it—then we urge that that provision be considered in the context of simplification and be dropped.

So if I am incorrect about that, I apologize. If I am correct about it, I am urging that it be dropped.

Mr. **McGrath**. Thank you for your testimony.

Mr. **Jenkins**. Mr. Archer.

Mr. **Archer**. Mr. Chairman, I want to apologize for being tied up with some other gentlemen and could not get here earlier. I have the greatest respect for Mr. Facciani and I want to compliment you for the presentation that you have made to this committee and the suggestions that you have made for improvement of H.R. 1864.

I would like to ask you this question. If your suggestions were adopted, would H.R. 1864 in your opinion be a workable proposal?

Mr. **Facciani**. Absolutely.

Mr. **Archer**. Thank you very much.

Mr. **Jenkins**. Mr. Gilla, did you complete, in response to Mr. Anthony, your recommendations?

Mr. **Gilla**. I thought I had, yes.

Mr. **Jenkins**. Thank you. Further questions? Mrs. Johnson.

Mrs. **Johnson**. I would just like to ask the other two witnesses if the kinds of recommendations that you proposed are adopted, do you think section 89 is workable?

Mr. **Gilla**. I feel very comfortable with this bill, as opposed to the old section 89, yes. I have started to take a look at how it might work in my own particular case, at Ball. The only difficulty, as I indicated to Mr. Anthony, is the treatment of the salary reduction credit issue. Otherwise, and I said in the statement, I think the committee has come 100 miles in getting us something we can work with.

Ms. **Gann**. I would agree that H.R. 1864 is a long, positive road that has been taken. I think if the issues on cafeteria can be cleared up and you can come to a consensus on what the right contribution rates should be, and how that should be evaluated, I think it is very workable.

Mrs. **Johnson**. I am particularly interested in preserving the cafeteria option. I think it is going to have more, not less, relevance in the future. So I hope you will follow carefully our work in that area, and be sure to share your thoughts with us as we try to refine that matter.

Thank you.

Mr. **Jenkins**. The committee expresses its appreciation of the panel for your very important testimony. Thank you very much.

The next panel is Benson Goldstein of the National Society of Public Accountants; Frank Arnall, Corporate Compliance Consultants; Scott Dowd, with Beneplex, Inc.

Thank you very much. Mr. Goldstein, we will hear from you first, please.

STATEMENT OF BENSON S. GOLDSTEIN, DIRECTOR OF CONGRESSIONAL RELATIONS AND TAX COUNSEL, NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

Mr. **Goldstein**. Thank you very much. My name is Benson Goldstein. I am pleased to be representing the National Society of Public Accountants. I am the national society's director of congressional relations and tax counsel.

The national society commends Chairman Rostenkowski and the House Ways and Means Committee for holding this most important hearing on the topic of H.R. 1864 and section 89 of the Internal Revenue Code.

As a professional society that represents over 23,000 independent accountants, enrolled agents and tax professionals, NSPA members provide accounting and tax planning services to over 4 million individuals and small business clients.

Based on a client profile survey conducted of NSPA members in 1987, it was found that 90.7 percent of their clients had under 20 employees. For this reason, it appears that NSPA members would continue to prefer the option of repeal of section 89. NSPA believes that section 89 should be viewed as one additional complex measure added to the Tax Code.

As currently drafted, section 89 only acts as a disincentive to the starting and operating of a small business. The national—society, however, does believe H.R. 1864 to be an important step in the direction of simplification of section 89.

In particular NSPA commends the policy objectives of the legislation, which are to promote broad-based health care for rank and file employees and to mitigate instances where lower paid employees receive significantly less health benefit coverage than higher paid employees.

In reviewing the bill, NSPA considers the design-based test of H.R. 1864 as a positive step toward simplification. This approach would apparently permit an employer to determine whether his health plan passes the test by reviewing the design of the plan at the beginning of the year. For this to work effectively, it is very crucial to the small business community that this design-based testing procedure lead to the development of prototype plans for employers.

In order to enhance the simplification objectives of the proposed test under H.R. 1864, the national society has several recommendations for improvements with respect to the legislation and its laudable goals.

According to the legislation, an employer is required to make core health coverage available to at least 90 percent of rank and file employees. This is a requirement that small businesses could inadvertently fail. Businesses with 20 or fewer employees may be particularly affected by this requirement. NSPA would recommend greater flexibility in this rule for small business.

The legislation also requires that core health coverage offered have an employee premium of $10 or less for single coverage or $25 per week for family coverage. This premium paid by employees would be indexed to the rate of increase in wages. It is NSPA's viewpoint that employee premiums, for purposes of the legislation, be indexed according to the inflation rate for medical costs.

Under the bill, an employer can disregard certain part-time employees for purposes of the nondiscrimination rules. Although H.R. 1864 does expand the current law definition of part-time employees from 17.5 hours to 25 hours per week, the national society strongly recommends the definition of part-time employees be expanded to 30 hours per week.

As stated previously, NSPA believes that the repeal of section 89 is the preferable solution for small business. However, in the absence of repeal, the national society recommends that section 89 not be made effective until a minimum of 12 months after regulations are publicly released by the IRS.

Ironically, for all of the significant social reasons for enactment of section 89, equality of health coverage continues to be overlooked for many small business owners. Self-employed persons are only allowed to deduct up to 25 percent of amounts paid for health insurance for themselves and their families.

In recognition of this situation, Representative Byron Dorgan has introduced H.R. 2121. NSPA strongly recommends due consideration of Mr. Dorgan's proposal by the House Ways and Means Committee. The legislation is most important in its support of retention of the 25 percent health insurance deduction for self-employed individuals and the concept that such persons should ultimately receive full deductibility of health coverage.

It is NSPA's pleasure that the House Ways and Means Committee has invited the society to testify at this most important hearing.

[The statement of Mr. Goldstein follows:]

Statement of Benson Goldstein, on Behalf of the National Society of Public Accountants

Introduction

My name is Benson Goldstein and I am pleased to be representing the National Society of Public Accountants (NSPA). I am the National Society's Director of Congressional Relations and Tax Counsel.

The National Society commends Chairman Dan Rostenkowski and the House Ways and Means Committee for holding this most important hearing on the topic of Section 89 of the Internal Revenue Code. In specific, the hearing is on H.R. 1864, legislation designed to simplify the nondiscrimination rules for employee benefit plans under Section 89.

As the professional society that represents over 23,000 independent practicing accountants, enrolled agents and tax professionals, NSPA members provide professional services to over 4 million individuals and small business clients. In particular, they offer their clients accounting, auditing, management consulting, financial planning, tax preparation, and tax planning services.

Based on a client profile survey conducted of NSPA members in 1987, it was found that 71.4% of the clients of NSPA members at that time had an annual sales volume of $250,000 or less. Further, 78.2% of these clients were found to have 10 or less employees, and 90.7% of these clients had under 20 employees.

From the perspective of a client profile of this type, it appears that NSPA members would continue to prefer the option of repeal of Section 89. NSPA believes that Section 89 should be viewed as one additional complex measure added to the Tax Code. As currently drafted, Section 89 only acts as a disincentive to starting a small business. The provision adds to the frustration level of persons who would ordinarily want to become an entrepreneur in our country. Due to the various qualification and nondiscrimination rules required by the present statutory language of Section 89, the provision should also be viewed as a measure which significantly increases the paperwork and recordkeeping burdens of the business community.

H.R. 1864 - Policy Objectives and Simplification

Although the National Society prefers repeal of Section 89, the Society believes H.R. 1864 is an important step in the direction of simplification of this Code provision. In particular, NSPA commends the policy objectives of the legislation, which are to promote broad-based healthcare coverage for rank-and-file employees, and to mitigate instances where lower-paid employees receive significantly less benefit coverage than higher-paid employees.

In reviewing the bill, NSPA considers the design-based test of H.R. 1864 as a positive step toward simplification of Section 89. Under this test, data collection would generally not be required of the employer. This approach would apparently permit an employer to determine whether his health plan passes the test by reviewing the design of the plan at the beginning of the year. It is hoped that this design-based testing procedure would lead to the development of prototype plans for employers.

The National Society does consider the simplification procedures contained in H.R. 1864 to be critical improvements in Section 89. NSPA does appreciate the apparent advantages of the legislation, which are reduced data collection, the availability of a design-based test for an employer's health program, and the offering of one-day-a-year testing to employers.

Recommendations For Further Simplification

In order to enhance the simplification objectives of the proposed test under H.R. 1864, the National Society has several recommendations for improvements with respect to the legislation and its laudable goals.

According to the H.R. 1864, an employer is required to make core health coverage available to at least 90% of rank-and-file employees. This is a requirement which many small businesses could easily, but inadvertently fail. Businesses with 20 or fewer employees may be particularly effected by this requirement. NSPA would recommend greater flexibility in this rule for the truly small of small businesses.

H.R. 1864 also requires that the core health coverage offered (by an employer) have an employee premium of $10 or less for single coverage or $25 per week for family coverage. The premium paid by employees would be indexed to the rate of increase in wages. It is NSPA's viewpoint that employee premiums for purposes of the legislation be indexed according to inflation rate for medical costs. This type of index is likely to more accurately reflect the rate of change in health insurance premiums.

Under the bill, an employer can disregard certain part-time employees for purposes of the nondiscrimination tests of Section 89. Although H.R. 1864 does expand the definition of part-time employees from 17.5 hours (which is current law) to 25 hours per week, the National Society strongly recommends that the definition of part-time employees be expanded even further. A preferred definition of part-time workers for smaller firms should be based on a level of 30 hours per week. This level is likely to more accurately reflect the realities of the American employment market of smaller firms.

As stated previously, NSPA believes that repeal of Section 89 is the preferrable solution for small business. However, in the absence of repeal, the National Society strongly recommends that Section 89 (or the simplified methods offered by H.R. 1864) not be made effective until a minimum of 12 months after regulations are publicly released by the Internal Revenue Service. This is particularly important to small business, especially during this decade of constant changes in the tax law and regulations.

Health Insurance Coverage For the Self-employed

Ironically, for all of the significant social reasons for enactment of Section 89, equality of health coverage continues to be overlooked for many small business owners. Self-employed persons (i.e., certain sole proprietors, partners, and S corporation owners) are only allowed to deduct up to 25% of amounts paid for health insurance for themselves and their families.

In recognition of this situation, Representative Byron Dorgan has introduced H.R. 2121. NSPA strongly recommends due consideration of Mr. Dorgan's proposal by the House Ways and Means Committee. H.R. 2121 is most important in its support of retention of the 25% health insurance deduction for self-employed individuals, and the concept that such persons should ultimately receive full deductibility of health coverage.

It is NSPA's pleasure that the House Ways and Means Committee has invited the Society to testify at this most important hearing. The National Society stands ready to help the committee in its efforts to simplify the procedures under Section 89 for small employers and the American workforce.

Mr. **Jenkins**. Thank you, Mr. Goldstein.

Mr. Arnall.

STATEMENT OF FRANK ARNALL, PRESIDENT, CORPORATE COMPLIANCE CONSULTANTS, INC., AND PRESIDENT, FLEXIBLE COMPENSATION, INC., MAITLAND, FL

Mr. **Arnall**. Mr. Chairman and honorable members, I am Frank Arnall, CLU, president of Corporate Compliance Consultants and Flexible Compensation, Inc. My firms aid small employers with the Government-required documentation, testing and reporting for section 125 plans, 401(k) plans, COBRA, and since May 1988, section 89 documentation, data gathering and testing. At the current time our business is concentrated in Florida and we have only recently prepared to service clients in other States.

As stated previously, H.R. 1864 as introduced on April 13 certainly eliminates most of the reasonable objections by small businesses to the section 89 benefits tax.

Also as was emphasized by the previous panel, the limitation on the exemption for salary reduction plans should be seriously considered in how it relates to small businesses. However, small businesses will still continue to offer flexible compensation plans regardless of the outcome because they need those plans to please employees, for cost containment which has been brought up numerous times today, and to give owners and other employers a choice of benefits.

The option not to test and to tax all highly compensated employees will not cause small businesses any hardship in 1990. And most will enjoy seeing the highly compensated personnel of the generally larger and better capitalized C corporations either lose exemption or incur additional cost to maintain it, because a level playing field helps all entrepreneurs.

Yesterday there was a lot of testimony from public employers, and I wanted to say that our firm has done section 89 compliance work for four cities, two school boards, and 17 hospitals. All of those had highly discriminatory plans even though by State statute the instrumentalities of the State were not allowed to be discriminatory. I need to point out that discrimination in benefits hurts all of us because it ultimately adds to the deficit. Unfair and excess benefits should be taxed.

However, most public employers and nonprofit employers should have little difficulty with section 89 compliance as their base plans are already nondiscriminatory in practice. It was the additional plans that they had that seemed to be discriminatory through the existing section 89.

Few public employers will have additional tax under either the current section 89 or the H.R. 1864 amendment because public employers and nonprofit employers should be expected to meet the documentation requirements with only minor modification to existing documents. It is small employers that have been exempted from ERISA and have not previously documented.

However, many of them will miss it because they are bureaucracies, and in bureaucracies responsibility has to be designated and budgetary authority granted. My brother Joe Arnall, who is a representative in the Florida Legislature which went into session into mid-April, introduced a bill giving the department of administration the responsibility and the budget to comply. Because it may be months before his bill passes, the State of Florida will likely miss the documentation and notification deadline. The FICA impact alone on the 350,000 employees is significant.

The major problems with H.R. 1864 I want you to resolve are, No. 1, the credibility problem; No. 2, the problem of how to treat fairly those who have already in good faith complied; and No. 3, I believe that those people who fail to meet the deadline on a timely basis should be treated differently from those who are in fact tax protesters.

The problem with the current law is that it is complex and the penalties on nonhighly compensated are unfair. Therefore, the entire package lacks credibility. Without credibility, voluntary compliance does not occur and a "let them catch me" attitude prevails. When otherwise responsible employers willingly break the law because they consider it too bizarre, the problem becomes too great to enforce.

I assure you that less than 3 percent of all employers have actually taken any steps toward positive compliance at this time. One of our associates at an April 1989 national meeting of benefit managers of larger employers found only 14 in 500 surveyed that expected to comply with the current section 89 law by July 1. That is less than 3-percent compliance by the largest and best informed employers. Most employers who have done anything at all have only written their congressmen asking for a repeal of section 89.

Most employers have been frozen into inactivity by the move to repeal section 89 and fully expect to be rewarded for their delay. Therefore, you need to act now, get this law passed whether it stays as a companion and both versions of section 89 will be allowed for the next several years or what. But you need to make a definitive statement prior to July 1, 1989 so that we have an opportunity to get America into compliance.

Recognize this year and future years compliance under either law which might take care of the cafeteria compliance problem. Also I suggest a transition allowance or a qualification year where if someone misses the notification deadline, later compliance would give them a pro rata qualification for the remainder of the year.

[The statement of Mr. Arnall follows:]

HR1864: A BENEFIT ADMINISTRATOR'S VIEW

Mr. Chairman and Honorable Members, I am Frank Arnall, CLU, President of Corporate Compliance Consultants, Inc. and Flexible Compensation, Inc. My firms aid small employers with the government required documentation, testing, and reporting for Section 125 plans, 401(k) plans, COBRA and, since May of 1988, Section 89 documentation, data gathering, and testing. At the current time our business is concentrated in Florida and we have only recently prepared to service clients in other states.

HR1864, as introduced on April 13, certainly eliminates most of the reasonable objections by small business owners to the Section 89 Benefits Tax. Small business owners will have no new tax because of Section 89, for even without Section 89, in 1990 and after, sole proprietors, partnerships and Subchapter S corporation principals will lose their 25% exemption on health benefit premiums. For the current year, the exemption from income for group life and disability premiums is not available to principals in proprietorships, partnerships and Subchapter S corporations.

The limitation on the exemption amount for salary reduction will not affect owners of those small businesses because the other code provisions will have already done the same thing. Small businesses may still offer Flexible Benefits for other valid reasons:

To please employees
To contain costs
To give the owners and other employees a choice of benefits.

The option not to test and to tax all highly compensated will not cause most small businesses any hardship in 1990, and most will enjoy seeing the highly compensated personnel of the generally larger and better capitalized "C" corporations either lose exemption or incur additional cost to maintain it. A level playing field helps entrepreneurs.

Most public employers and non-profit employers should have little difficulty with Section 89 compliance as they are already non-discriminatory in practice, but may lack only full notification and documentation required by Section 89. Few public employees will have additional tax under either the current Section 89 or the HR1864 amendment, because public employers and non-profit employers should be expected to meet 89(k) requirements with only minor modification to existing documents. However, most public and non-profit organizations will not meet the 89(k) deadline because of the general publicity that this law would be repealed and because in bureaucracies responsibility has to be designated and budgetary authority granted.

My brother, Joseph Arnall, a Representative in the Florida Legislature which went into session in mid-April, recently introduced a bill giving the Department of Administration the responsibility and the budget to comply. Because it may be months before his bill passes, the State of Florida will likely miss the 89(k) notification deadline. The FICA impact alone on 350,000 employees is significant.

The problems I want you to resolve with HR1864 are:

1) The tax on benefit reimbursements for calendar year 1989
2) The credibility problem
3) The problem of how to treat fairly those who in good faith complied now.
4) Those who should have met the deadline but do comply comply late should be treated differently from those who are tax protestors.

The problem with the current law is that it is complex and the penalties on non-highly compensated are unfair. Therefore, the entire package lacks credibility. Without credibility, voluntary compliance does not occur and a "let them catch me" attitude prevails. When otherwise responsible employers willingly break the law because they consider it too bizarre, the problem becomes too great to enforce.

I assure you that less than 3% of all employers have actually taken any steps toward positive compliance. One of our associates at an April 1989 national meeting of benefit managers of larger employers found only 14 in 500 that expected to comply with the current Section 89 law by July 1. That is less than 3% compliance by the largest and best informed employers. Most employers, who have done anything at all, have only written their Congressman asking for repeal of Section 89.

This type of widespread resistance to conform with a new employee benefit law has happened before. COBRA met the same kind of resistance. Although few would argue the fairness of the continuation provisions, the penalties were such until six months ago that few employers believed it would ever be enforced. Virtually every employer violated some aspect of COBRA and, even now with new reasonable sanctions in place, our experience is that fewer than half of all employers are consistently in compliance with COBRA.

Congress has passed so many employee benefit laws in such a short period of time with such powerful sanctions that employers are bewildered, angry and afraid. The benefit laws have lost credibility because even the I.R.S. has been unable to keep up with the requirements and the multiple changes to those requirements. Few professional benefit and tax advisors have found it a worthwhile use of otherwise billable hours to attempt to keep up with Section 125 and COBRA much less Section 89! There is very little reasonably priced expert help available to most employers.

Most employers have been frozen into inactivity by the move to repeal Section 89 and fully expect to be rewarded for their delay. They really expect Section 89 to be repealed. Because of the general confusion and doubt, few professional advisors are prepared for the current July 1 deadline. However, those employers who have in good faith attempted to comply with Section 89 should be rewarded. You must always encourage voluntary compliance with any tax law. HR1864 as an appropriate and understandable solution to the Section 89 benefits tax in 1990. But, as simplicity leads to certainty in compliance, you need to help the situation in 1989 as well. Therefore, please amend HR1864 to ensure fairness and equity for 1989. I make the following recommendations:

1. Make HR1864 effective July 1, 1989. This earlier effective date will make a statement that Section 89 is here and must be dealt with now.

2. Recognize for this calendar year compliance under either current Section 89 or HR1864 testing procedures because you have an obligation to act fairly for those few who have, in good faith, spent money on Section 89 compliance.

3. Have transition rules for the penalties.

    a. A late compliance excise tax of 10% of the value of the benefits as defined in HR1864 if compliance is completed before the beginning of the 2nd Section 89 year. This provision would encourage compliance even if documentation deadlines are initially missed.

    b. Income Tax exemption for employer subsidies for any Specified Employee Benefit Plan for any employer should commence the first of the month following the filing of a copy of the employee notification of such benefit with the Department of Labor. The initial "Qualification Year" would then be the unexpired months of the plan year. A proof of mailing would act as the "gatekeeper" requirement.

    c. The 34% excise tax would then apply only to those employers who not only did nothing to comply with Section 89 this year, but also excluded the benefit costs from the income of the affected employees.

I believe HR1864 strengthens Section 89 so that general compliance will soon commence and that revenue will be raised from excess and discriminatory benefits received by highly compensated employees. I am concerned, as you are, that the clear message of compliance necessity be sent out now; that those responsible employers who will meet the current notification deadline of July 1 or later plan date be treated fairly; and that those who comply soon after missing the initial plan date will pay less penalty than those who continue to put off real compliance and merely lobby and contribute to PAC's in an effort to repeal this basically good law that encourages fairness and equity in benefits.

Mr. JENKINS. Thank you, Mr. Arnall.
Mr. Dowd.

STATEMENT OF SCOTT DOWD, PRINCIPAL, BENEPLEX, INC., ST. PETERSBURG, FL

Mr. DOWD. Mr. Chairman, ladies and gentlemen of the committee, my name is Scott Dowd. I am the managing principal of Beneplex, Inc. Beneplex is a specialty consulting and administrative services firm offering employer-clients services for governmental compliance. Section 89 compliance would be a service that we would offer our clients. Our clients are drawn from the Tampa Bay area in the State of Florida.

Today we are being asked to consider whether the law as stated in IRC section 89 and its proposed regulations is adequate to serve its intended purpose. That purpose as articulated by the chairman, is to increase the availability of affordable health care to a greater number of Americans. The efficient means of achieving this purpose is a series of financial penalties against highly compensated employees who presumably control the employer's decision to sponsor and pay for the health care plans of their employees. In essence, this approach has been conceived to be adversarial. It is a win or a lose game.

Under the present construction of section 89, an elaborate series of qualification standards and nondiscrimination tests conspire to produce a result which I feel is exactly opposite to the best hopes and wishes of this committee. While the penalties for noncompliance may achieve the desired revenue goal of some $180 million, the cost of noncompliance may very well appear to be less expensive to many employers than the cost of compliance. We are therefore confronted with a quid pro quo. If the committee purpose is to achieve revenue first, then section 89 works in its present form. If expanded health care coverage is desired, section 89 must be changed. I suggest to you, ladies and gentlemen, that the change must be a conceptual change; a change of form over substance.

The State of Florida is home to over 10 million people. Some projections show 12 million people during the 1990's. Recent studies show that in excess of 2 million people in Florida are uninsured. So this question deeply affects my home State. The greater metropolitan Tampa Bay area houses close to 2.5 million people. In 1988, a typical Tampa Bay employer with 30 employees who provides a standard comprehensive major medical indemnity plan as a fringe benefit would have paid monthly premiums of $70 for each employee covered and $195 for each dependent unit covered. In 1989, that same plan will renew for $100 per employee unit and $275 per dependent unit, a rate increase of over 40 percent in 1 year. As a practical matter most employers do not pay the same percentages for dependent health care when compared to employee-only coverage. Significantly less contributions to the dependent health care side are the typical condition.

Under H.R. 1864 the requirement to make available affordable health care coverage will double the employer's cost for the identical plan. By requiring under the bill's eligibility test the availability of dependent health care at a cost judged to be affordable by an employee, the employer must now assume significant additional cost. Presumably the ultimate effect will be noncompliance or the creation of bare bones plans with limited coverage.

While increased employer cost may be the proximate result of this amendment, the longer term result is even more insidious. That is the phenomenon of adverse selection. Availability of health *care is not coverage. Regardless of whether or not health care* is available or even affordable the people who seek coverage are, in a statistical sense, the ones who need it. Given an option the young, healthy employee will not choose to buy health care. The combined risk pool under the proposed amendment will gradually become older and less healthy.

Given this scenario, questions of affordability and availability will become irrelevant. Healthy people will prosper while unhealthy people will become wards of the State.

I suggest to you today that issues of availability, affordability and health access do not address themselves to the correct solution. A real world needs real solutions. A conceptual approach that promotes adversarial positions will not work. What is needed is a cooperative model based on mutual self-interest. What is needed is coverage, real coverage. And the way to achieve it is through employer incentives to provide additional plans for a larger group of employees.

Tests that are based on employer-provided coverage can be linked to income exclusions, or even to continuation of expense deductibility to achieve the desired result. The greater the percentage of covered employees, the less the penalty, or better yet, no penalty at all. The promotion of section 125 cafeteria plans as helper devices to achieve coverage should be seen as positive reinforcements. By encouraging an increase in medical expense reimbursement plans and dependent care assistance plans, multiple purposes are served—all to the benefit of employees.

The following circumstances must also be considered carefully. Extension of coverage to the contingency work force should be approached with care due to the high potential for adverse selection.

A return to the qualified plan standard for coverage of leased employees should be avoided. Leasing companies exist to create economies of scale for their clients and are much better able to create and maintain coverages for the leased employee.

The current sworn statement rule creates an excessive administrative burden. This rule places the employer in the position of policing his own employees about private decisions for alternate coverage. A simple employee declaration of waiver is sufficient.

The availability test will penalize smaller employers with older female workers since health insurance premiums are related to age and sex characteristics. Whereas a coverage test will amortize any added demographic risk over a younger mix of workers.

In closing, we all recognize that the members of this committee have been struggling long and hard with a myriad of revenue issues, very few of which have some clear answers. To attempt to solve the health care crisis with a deep pocks punitive approach to employers sends the wrong message. It says that employers are responsible for the problem. In fact, we are all responsible—the Congress, employers, the health profession and even the people themselves. Penalties will not work, they will only produce money. If that is what is really wanted then these conversations are merely academic. If we want a real solution, then we must discover additional ways to cooperate.

I thank you, Mr. Chairman, for the opportunity to submit these comments and would be happy to respond to any questions which the committee might have.

Mr. JENKINS. Thank you, Mr. Dowd.

Are there questions from the committee? Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman. I would only take issue with, Mr. Dowd's, position on why H.R. 1864 was introduced. It is my judgment that the bill was not introduced to mandate health benefits. There is another bill out there that would do that in a better way, shape and form.

No. 2, I do not believe we did this with the eye to raise revenues because I have not seen any revenue model that would create or give us $180 million of revenue through whatever sanctions that may be imposed.

Rather, I believe that the whole idea was that for those who are presently providing health benefits that the issuance of those health benefits should be across the board and equal in nature. I do not like, frankly, to look at this in terms of either a mandated benefit bill nor a sanction bill that is only in existence to create revenue for us even though we probably need it very badly.

Thank you.

Mr. JENKINS. Are there further questions?

Mrs. Johnson.

Mrs. JOHNSON. I just wanted to comment on the universality of the comment we have heard this morning on the need to exclude part-time employees. Some of you have defined that as 30 hours a week, others of you have defined it in other terms. But I think that ought to be noted, and I appreciate the specific nature of your testimony.

I want to just ask whether in your experience out there, not just because of section 89 but COBRA and a number of other things, to what extent do you believe small businesses are either dropping or deciding not to enter the health care business for their employees? Is that a big issue or a little issue or a medium-sized issue?

Mr. ARNALL. It does not make any difference, Mrs. Johnson, because for small businesses right now, in general proprietorships, sub-S corporations, they only have a 25-percent health exclusion and no exclusion for tax-favored group term insurance or disability insurance or reimbursement allowance. So with only 25 percent of the health premium, that is not a decision.

What is the determining thing is the marketplace. That is why if you are going to have a gateway of 90 percent or 85 percent or 70 percent, whatever you arrive at as the gateway requirement for the cliff test to decide whether or not you are providing in fact a broad-based plan or not, then a dollar amount does not make sense.

Beyond that, what fits into that gateway, it needs to be that the highly compensated people, all highly compensated people whether they are sole proprietors or whether they are executives in C corporations would get a multiple of either the lowest dollar amount using and obtaining that cliff test or the same percentage of employer cost. So that if the employer is paying 50 percent of its least paid employee, then it would then pay 67 percent of its highest paid employee.

Mrs. **Johnson**. So one of the things you are concerned about is that we straighten out this problem of how the small employer is treated and at least encompass him in this law and treat him the same as everyone else?

Mr. **Arnall**. Exactly. I was going to say, right now we sell cafeteria plans. A large number of our companies, the executives under those cafeteria plans get no benefit because it is an altruistic thing for the employees because the existing rules restrict them to 25 percent.

Mr. **Goldstein**. I would like to clarify on that point. The 25-percent health insurance deduction is sunset for December 31 of this year. It was included in the 1986 act and it was sunset to go out of effect at the end of this year, unlike C corporations that have 100-percent deductibility. We would strongly recommend that your committee look at that issue and retain the 25-percent deduction before it expires at the end of this year, and ultimately go to full deductibility for the self-employed.

Mrs. **Johnson**. Thank you very much.

Thank you, Mr. Chairman.

Mr. **Jenkins**. I want to thank the panel very much for your testimony. Thank you so much.

Our final panel is Mary Hevener, Edwin Peacock, Jr., and Charles Gallagher, Jr. Your written statements will be made a part of the record as presented. Now we will hear from each of the panelists a summary of their testimony.

Ms. Hevener.

STATEMENT OF MARY B. HEVENER, ESQ., PARTNER, LEE, TOOMEY & KENT, WASHINGTON, DC

Ms. **Hevener**. Thank you, my name is Mary Hevener. I am a partner in the Washington law firm of Lee, Toomey & Kent. I am also, unlike most of the other people here today, the author of a book on section 89. I am told in some weeks during the preceding year it was selling slightly faster than Satanic Verses. There are 12,000 employers that have purchased copies of this 350-page book. In part I come to testify on behalf of those employers who are being frustrated by what I have written, and in part I am testifying on behalf of some of our corporate clients that have relayed comments to me about H.R. 1864.

I am pleased to have the chance to be here today. I support enthusiastically the efforts made by H.R. 1864 to simplify the testing process. I have some additional simplifications to suggest, and I also have some suggestions about lessening the penalties for failing the nondiscrimination requirements.

Also unlike some of the other people testifying today though, I have suggestions on how to raise revenues for some of the long lists of changes that people have been suggesting over the past couple days of the hearing. I have seen a lot of plans over the course of the past year be tested under the existing section 89 rules. I have talked to a lot of companies and assessed what the damages are going to be under H.R. 1864, which predominantly has a negative effect on the cafeteria plans which are sponsored by a number of our clients.

In talking to the people and in seeing the kinds of benefits that are failing discrimination tests right now, what the tests boil down to is that medical reimbursement accounts are failing, executive physicals are failing, and AD&D insurance is failing. I think you would have a much more up-front bill if you sat down now and attempt to cap medical reimbursement accounts at $2,000, say that any executive physicals are taxable to the executives, and specify dollar limits on AD&D insurance.

There has been no effort yet in section 89 to come out and talk about specific benefits. Over and over again people cannot believe after they have read a 350-page treatise and looked at their plans that really this will have any impact on them. I think if the legislation went forward in a more straightforward fashion and attempted to cap some of these benefits by looking at them specifically, you may be able to raise some revenue that will ultimately be lost in the long run.

The other way that my testimony is differing from that of some of the preceding speakers is that I think H.R. 1864 as it is presently drafted is one of the largest incentives for the creation of cafeteria plans that has come down the pike since Treasury said that you could establish these plans and fund them on a salary reduction basis.

Under current law we have a limit of 7½ percent of AGI on the deductibility of medical expenses. Under current law, as you have just discussed, we have a 25-percent deduction for health insurance costs for self-employed individuals. For people in cafeteria plans you neatly avoid the 7½-percent limit of AGI if you set up a medical reimbursement account. You can effectively deduct your first dollar. You can pay for your glasses. You can pay for your aspirin. You can pay for your deductible insurance premiums and all your uninsured medical expenses. You cannot deduct those items if you are not in a cafeteria plan because you are affected by the 7½-percent limit.

Self-employed people do not get any deduction at all next year. They get to deduct 25 percent of their health insurance now. I think one thing that people are failing to realize as part of the attraction of cafeteria plans is that you are able to avoid these limitations on what you can deduct for health expenses now. H.R. 1864 is going to make even more popular these cafeteria plans because of the effect of the $10 and $25 limits the way they stand.

There is no discussion in these bills about the size of the deductible in this core, or primarily core health insurance plan, that has to be established in order to offer affordable health insurance. You could easily offer employees insurance that costs $520 a year with a $2,000 deductible and a 90-percent copay. Lots of companies may not go to that dramatic extreme, but they are going to reduce their benefits in order to meet the $10 and $25 limits. And it is likely in instituting these increased deductibles that they will set up a cafeteria plan as well. It makes the bad news for employees a little more palatable.

I think in recognition of the fact that these plans will be set up you should think now about capping these medical reimbursement accounts with just a dollar limit of say $2,000.

[The statement of Ms. Hevener follows:]

STATEMENT OF MARY B. HEVENER
LEE, TOOMEY & KENT

BEFORE THE COMMITTEE ON WAYS & MEANS
HEARING ON H.R. 1864
SIMPLIFICATION OF CODE SECTION 89
MAY 3, 1989

My name is Mary B. Hevener. I am a partner in the Washington, D.C. law firm of Lee, Toomey & Kent, and the author of a book, A Practical Guide to Section 89 Compliance, which deals with exactly the topic of the Committee's hearings today and yesterday, that is, the unnecessary complexities of current Code Section 89. I am testifying today on behalf of many of the large corporations that are clients of Lee, Toomey & Kent, and also on behalf of the 12,000 frustrated employers who have subscribed to my book.

I am pleased to have this chance to appear before the Committee, to support enthusiastically your efforts to simplify Section 89, and to request a number of additional improvements both to simplify the testing process provided by H.R. 1864, and to lessen the penalties for failing these nondiscrimination rules.

Essentially, H.R. 1864 replaces the two-part, and alternative four-part tests of current law with one two-part mathematical test, and one general "smell test", that may eliminate inherently discriminatory health plans. The mathematical test provides that at least 90 percent of the rank-and-file employees must be eligible for health insurance for which they pay no more than $520 per year for individual coverage, and no more than $1,300 per year for family coverage. This plan must also be at least 75 percent as valuable as the total package of health benefits provided to any highly compensated employee. Said another way, no high-paid employee can receive tax-exempt health benefits worth more than 133 percent of the employer's cost of affordable health insurance offered to 90 percent of its rank-and-file employees. The side effect of these simpler tests is that they eliminate any need for complex plan aggregation rules, as well as the burdensome sworn statement requirements of current law.

H.R. 1864 makes a number of additional simplifying changes in response to widespread complaints about Section 89, including:

(1) raising the cut-off limit for excludable part-time employees from 17-1/2 to to 25 hours per week;

(2) permitting the exclusion from testing of leased employees so long as those employees are covered by health insurance, and do not comprise over one-fifth of a workforce;

(3) requiring separate testing of collectively bargained health benefits;

(4) postponing until 1990 the deadline for testing former employees' health benefits;

(5) testing group term life insurance under the rules that applied prior to the 1986 Tax Reform Act; and

(6) imposing penalties for failing the Section 89(k) plan qualification requirements on employers, not employees.

All of these beneficial changes are apparently paid for by a rule that would specifically restrict the tax-effectiveness of cafeteria plans for high-paid employees. This new rule, which is harsher than current law, requires that salary reduction benefits be disregarded in determining the value of the basic health plan for rank-and-file employees. Once this limit plan is determined, 133 percent of that plan's value will be the maximum level of tax-favored health benefits for highly paid employees. Thus, for any employer that requires employees to pay for 25 percent of the total premium cost for core health coverage on a salary reduction basis, this rule would require high-paid employees to be taxed on all health benefits in excess of the value of that core health plan for rank-and-file employees. If employees must pay more than 25 percent of the premium cost, part of the value of even the core health insurance plan would be taxed to high-paid employees.

Better Ways to Pay For Simplification

This proposed harsh rule for cafeteria plans has been criticized by almost every speaker at these hearings, with good reason. It is not fair to disregard salary reduction contributions by rank-and-file employees, while counting all salary reduction contributions by high-paid employees. More importantly, this purported restriction on cafeteria plans, standing alone, is also not likely to be revenue-effective in the long run, as I discuss in more detail below.

A much better way to pay for these beneficial changes proposed in H.R. 1864 would be to impose direct, clear-cut limits on the types of health benefit plans that typically cause discrimination problems. In my experience, there are three types of plans that consistently fail the nondiscrimination tests of current law, and that also would fail the rules as proposed by H.R. 1864. These are:

- medical reimbursement accounts;
- executive physicals; and
- accidental death and dismemberment ("AD&D") insurance.

Wouldn't it be easier, and much more direct, simply to:

- place a dollar cap (of perhaps $2,000) on the amount of benefits that can be paid under a medical reimbursement account to any employee, whether high-paid or low-paid;
- tax all physicals (unless they are also provided to rank-and-file employees); and
- tax all AD&D insurance in excess of specific dollar limits?

These clear-cut limits on health exclusions could then be coupled with rules, similar to the current eligibility and benefits tests in H.R. 1864, except that salary reduction benefits could then equitably be counted for all employees. This test, as revised, would require employers either to provide health insurance to rank-and-file employees that is at least 75 percent as valuable as health insurance for any high-paid employee, or to tax high-paid employees on the value of all of their health benefits.

Difficulty of Isolating Salary Reduction Benefits

I think you will find, if you prepare dynamic revenue estimates of my proposals outlined above, as compared to those in H.R. 1864, that my clear-cut limits raise far more revenue over the long run. They also eliminate the virtually unadministrable requirement that "salary reduction benefits" (whatever that term may mean) must be isolated and subtracted from the benefits package for non-highly compensated employees, in order to calculate a health benefit "value" that, when multiplied by 133 percent, can limit the aggregate value of tax-exempt health benefits that may be provided to highly compensated employees.

The identification of "salary reduction benefits" is difficult, because this term is not defined merely by reference to the simple case, where an employee decides to reduce his or her salary to receive tax-exempt benefits. Instead, it is defined by reference to whether an employee has a choice between cash or nontaxable benefits.

Under many flexible benefits plans in operation today, employees are given "flex dollars" that may not bear any constant proportional relationship to the value of the benefits than can be purchased, but which may be allocated under the plan among a broad range of taxable and nontaxable benefits. For example, assume an employee is given $2,000 in "flex dollars," to allocate among health plans ranging in value from $2,000 to $6,000, dependent care benefits worth $4,000, tax-exempt group term life insurance worth $500, and taxable benefits worth $2,500, including cash of $600. At least $2,000 of health insurance must be purchased, but the flex dollars can otherwise be allocated however the employee prefers, to purchase benefits at prices specified in the plan. What is the "salary reduction" on these facts? Should we pick $2,500, the maximum amount of taxable benefits that can be purchased? Should that value be reduced, in cases where a particular employee could not have used a particular taxable benefit (such as spousal insurance for a single employee)?

The examples presented in actual practice become much more complicated that the one set forth above. However, if employers were simply allowed to include salary reduction benefits of all employees participating in flexible benefits plans, plans like the one outlined above would automatically pass the new 90 percent/75 percent test, because all employees would be eligible to elect up to $6,000 of health benefits, whether they are high paid or low paid.

Eliminate the $10/$25 Tests for Affordable Health Insurance

Many comments have also been made at these hearings that the proposed $10 and $25 weekly limits used to define "affordable" health insurance for rank-and-file employees should be raised and/or indexed to increase with some medical cost inflation index instead of with the wage index. Arguments have been raised, and I agree with them, that if these limits are correct, current estimates of the maximum portion of health insurance costs that should be passed on to employees, these dollar limits should be indexed to increase with health insurance costs, in order to keep constant that employee-pay portion of health insurance.

However, instead of merely changing the inflation index applied to these limits, I suggest instead that these dollar limits should be eliminated altogether, for two reasons. First, the way H.R. 1864 is currently structured, these "affordability limits" will prevent employers from offering bonuses to employees who have other insurance, and elect out of the employer's health plan.

For example, a plan offered by one of my firm's clients currently provides a basic health plan at no cost to employees, but also generously pays a refund of $900 per year to any employee who proves that he or she has other health insurance, and therefore declines coverage under the company's plan. We are concerned that this refund paid to employees that elect out of health coverage would be viewed as an "employee charge," that then would fail the $520 per year limit imposed on employee charges by H.R. 1864. In order to satisfy these proposed "nondiscrimination rules," this employer would have to limit its refund to rank-and-file employees to $520 per year (although high-paid employees could still receive the larger $900 refund). This surely is not the type of result that you contemplated in drafting this reform proposal.

My second reason for suggesting that these dollar limits should be eliminated is that I believe they will create the largest single incentive for the establishment of cafeteria plan reimbursement accounts that has ever been enacted, under the guise of "nondiscrimination rules."

I used the phrase "dynamic revenue estimates" earlier, because I doubt that that the estimates performed to date on H.R. 1864 have considered that most employers that cannot satisfy your dollar limits will simply increase the deductible limits and co-pay requirements under their existing insurance plans, until the plans nominally satisfy the $10/$25 weekly limits. To sweeten the bad news for employees about these increases in deductibles and co-pays, it is likely that employers will establish cafeteria plan reimbursement accounts, under which rank-and-file employees could cover these increased health costs, and thus share these costs with the federal, state, and local governments.

Cafeteria plans are already responsible (according to estimates made in 1985) for revenue losses in excess of $10 billion per year. If you are seeking to increase that revenue loss dramatically, by encouraging more and more employers to establish plans that enable their employees to avoid completely the limit of 7.5 percent of AGI that is currently imposed on the deductibility of uninsured health expenses, then you should definitely enact H.R. 1864. If, on the other hand, you simply want to encourage employers to offer some sort of health insurance to employees, then say so, without imposing artificial, and easily avoided, limits on the price that employees must pay for that insurance. As a separate measure, I am proposing that you address the root problem of the cafeteria plan revenue drain, which is the payment of uninsured medical expenses through medical reimbursement accounts, primarily ones funded by salary reduction.

Delay Application of Rules to Leased Employees

Another favorite topic of criticism at these hearings has been the application of the nondiscrimination rules to leased employees. I heartily agree with all of the comments about the difficulties and expenses of identifying leased employees, of obtaining information on their insurance coverage from leasing companies, and of trying, in the case of self-employed leased employees, to apply mathematical tests to coverage valued by reference to the 25 percent deduction for health insurance that is currently allowed under Code Section 162(m).

I would add, to all of these complaints, a concern about the additional potential revenue loss that you have created here, by providing that "leased employees" (however that term may be defined) are to be treated as common law employees, for purposes of obtaining the exclusion for health benefits available under Code Section 105, and also for purposes of participating in any cafeteria plan. This rule, under both current law and H.R. 1864, will enable any leased employees to pay for all of their health benefits on a salary reduction basis.

There are millions of self-employed workers in America who would jump at the chance to pay for all of their health insurance, plus all of their uninsured medical expenses, on a pre-tax basis. If the definition of a "leased employee" remains as vague as it is under current rules, you are creating yet another incentive for companies to offer to bring thousands of their independent contractors into their health plans, by requiring them to pay for their health benefits on a salary reduction basis. Your revenue estimators are calculating a very high revenue loss for extending beyond 1989 the 25 percent deduction under Code Section 162(m). Would that loss be so high, if they understood, or prepared dynamic estimates for, the fact that any self-employed person who works for any company for more than 6 months and more than approximately 30 hours per week, could buy 100 percent of all health benefits, on a tax-preferred basis, though a cafeteria plan?

To solve this potential revenue drain, I suggest, instead of the proposal on leased employees contained in H.R. 1864, that, at least for a few years, you simply:

(1) require independent leasing companies to test their own health benefits, including the benefits provided to employees who are leased to other organizations; and

(2) provide whatever direct deduction you can afford to independent contractors.

However, I strongly recommend that you abandon any effort to require companies for whom these "leased employees" are working to include leased employees in their Section 89 tests, unless, as explained above, you intend to encourage the extension of cafeteria plans to all of these unidentified individuals. Testing of leased employees by the companies for whom they are working should be required only after you have devised a clear-cut standard for identifying leased employees (including independent contractors who so qualify), who have no other health benefits, and who should therefore be entitled to coverage (including coverage on a salary-reduction basis) under the health plans of the companies for whom they are performing services.

Eliminate Testing of Employees of Foreign Affiliates

One problem that has not even been raised by most of the employers complaining about Section 89 is that it currently applies around the world, to any U.S. citizens working in any country. This requirement of current law raises such mind-boggling complexities, that most employers have simply decided to ignore the rule. It will be next to impossible for many of these companies to discover the citizenship of foreign nationals with dual citizenship. As a result, most multinational corporations could never say, with certainty, that they have passed the 90 percent eligibility test, because they may never be able to determine whether these foreign-based U.S. citizens, together with uninsured leased employees, on top of uninsured part-time employees, may total more than 10 percent of a worldwide workforce. Section 89 creates enough problems when it is confined to U.S. borders. It would seem advisable, therefore, to exclude from testing all U.S. citizens, as well as all other employees, who are working abroad.

Revision of Benefits Testing for Employer-Provided Child Care

Amid all the praise and complaints about reform of the nondiscrimination rules applicable to health benefits, there has been little talk about the nondiscrimination rules applicable to dependent care assistance programs. Under current law, dependent care assistance plans must be subjected to nondiscrimination testing under either the 55 percent benefits test of Code Section 129(d)(7), or (at the employer's election) the more difficult three-part tests of Section 89. The Section 89 tests might be elected, for example, if the exclusions for educational assistance and group legal services benefits are extended through December 31, 1989, and an employer wanted to combine all three benefits for testing purposes.

Under H.R. 1864, dependent care benefits must be tested under the 55 percent benefits test, with no opportunity to apply the line of business rules, the single testing date requirement, or the discriminatory excess carve-back rules that would be available, under current law, if testing under Section 89 were elected. Admittedly, H.R. 1864, as is is presently drafted, is not conceptually applicable to child care benefits. However, these three helpful testing rules listed above should be added to Section 129. Under these three rules, employers could: (1) test employees' dependent care benefits on a line of business basis, instead of on an employer-wide basis; (2) measure benefits provided as of a single testing date, instead of monitoring benefits elections of rank-and-file employees throughout the plan year; and (3) tax high-paid employees on their discriminatory benefits, instead of risking disqualification of the entire plan, if any of the benefits provided thereunder inadvertently fail the 55 percent benefits test.

Minor Changes in Plan Qualification Rules

H.R 1864 moves to Code Section 4980C, without material change, the five qualification rules of current Code Section 89(k), that require plans to be in writing, explained to employees, in effect for at least 12 months, legally enforceable, and maintained exclusively for employees' benefit. Chairman Rostenkowski's floor statement in explanation of these rules mentioned one very helpful change, that I hope will ultimately be reflected in the statute, which is that de minimis failures of the exclusive benefit requirement would not disqualify any plan. I was concerned, however, that this suggested helpful change was omitted from the Description of H.R. 1864 that was prepared for these hearings.*/

One additional change that should be made in the qualification rules is to exempt from the tests any company cafeterias. Treasury's regulations already exempt company cafeterias from the "written plan" requirement (perhaps under the theory that there are already enough "cafeteria plans"). However, under current rules, employees must also be able to legally enforce their rights to eat in the employer's cafeteria, and must receive "reasonable notice" of the cafeteria's existence. These and the other plan qualification rules should no longer be applied to company cafeterias.

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*/ Compare 135 Cong. Rec. H1207 (April 13, 1989) to Description of H.R. 1864 Relating to Simplification of Section 89 Nondiscrimination Rules Applicable to Certain Employee Benefit Plans, Prepared by the Joint Committee on Taxation (April 26, 1989) at 25.

Reform of Penalty System

My final suggested reform involves the unnecessarily harsh penalties that apply under both current law and H.R. 1864, to any failure of either the Section 89 nondiscrimination rules, or the five-part plan qualification requirements.

First, with respect to failure of the nondiscrimination rules, reason dictates a reduction in the potentially enormous penalties that currently apply if discriminatory excess benefits are ever funded through either VEBAs or retired lives reserves ("RLRs"). For example, the VEBA penalty on health benefits for retired employees that are correctly reported as "discriminatory excess" imposes on the employer a 134 percent nondeductible excise tax, times the value of the correctly reported discriminatory excess benefits. Even more dramatically, the penalty for providing discriminatory benefits to a single employee under a retired lives reserve can eliminate the employer's deduction for the entire RLR!

Treasury's regulations currently allow these penalties to be avoided only if employers require high-paid employees to pay for their discriminatory benefits with after-tax dollars. Of course, if employers pay bonuses to these employees, to be used to pay for these benefits, both the employer and the employee are in precisely the same positions that they would be in, if the employee had simply been taxed on the benefit, instead of on the cash used to pay for the benefit. This two-step process should be eliminated. Employers should instead be allowed to tax high-paid employees on any discriminatory benefits, without calling these benefits "discriminatory excess," and thereby triggering enormous VEBA and RLR penalties.

My final comment concerns the proposed penalties for failing the plan qualification requirements. Under current law, the so-called "penalty on the sick and the dead" requires the inclusion in incomes of sick employees, or beneficiaries of deceased employees, of all insurance proceeds paid under any health insurance or group term life insurance plan, respectively, that may have violated any of the plan qualification rules.

Treasury's regulations helpfully limited the impact of this penalty, at least for health insurance proceeds paid to rank-and-file employees, so that the included income can never exceed specific (and increasing) percentages of the sick employee's compensation (as measured before inclusion of the violative health benefit). Specifically, in 1989, the amount of health benefits taxable to any employee because of a Section 89(k) violation is limited to the amounts set forth below:

Employee's Compensation	§89(k) Penalty Maximum
$0 through $54,480	10% of compensation
$54,481 through $108,960	$5,448 plus 25% of comp. over $54,480
$108,961 through $163,440	$19,068 plus 75% of comp. over $108,960
above $163,440	$59,928 plus all of comp. over $163,440

H.R. 1864 introduces another helpful change, by taxing the employer, instead of all employees (or their beneficiaries), in the event of any failure of the plan qualification rules. This proposal has been hailed as beneficial, mostly because it applies to a less sympathetic taxpayer - the employer. However, speaking on behalf of employers, I urge you to incorporate the proposals contained in Treasury's regulations, limiting, to 10 percent of compensation, the amount of insurance proceeds and other employee benefits that could ever be subject to this new 34 percent nondeductible excise tax.

In conclusion, and again on behalf of the employers who are either my firm's clients, or are the purchasers of my book, I thank you for this opportunity to testify on H.R. 1864, and I heartily support your efforts to streamline the testing process, and to lessen the testing penalties.

Mr. **Jenkins**. Thank you.
Mr. Gallagher.

STATEMENT OF CHARLES B. GALLAGHER, JR., BOWMAN, BOGGS & GALLAGHER, MORGANTON, NC

Mr. **Gallagher**. Thank you, Mr. Chairman. It is my privilege and pleasure to have the opportunity to participate in the public discussion of H.R. 1864 and as the next to the last speaker I will try to keep my public comments brief.

My name is Chuck Gallagher, and as a practicing certified public accountant in North Carolina, a member of the AICPA in the North Carolina Association of CPA's, and a certified public accountant practicing extensively in the area of employee benefits and executive compensation, I am pleased to see H.R. 1864 being introduced as a substitute for present IRC section 89. Certainly the Committee on Ways and Means and specifically Chairman Dan Rostenkowski have shown wisdom in considering simplification of Tax Code section 89 while retaining the originally conceived tax benefits.

Obviously section 89 in its present form requires complicated testing procedures be done for all accident and health and/or group term life insurance plans or significant penalties on not only the employer but nonhighly compensated employees could occur. As a result, many corporate entities along with employee benefits professionals feel the administrative responsibility and the burden of section 89 as it presently exists is terribly burdensome.

As a result of the above, many have felt that the repeal or postponing of section 89 was appropriate. I, however, do not share that view. Over the past 8 years our Federal tax law has undergone significant change and we feel that Congress must not only look at the tax implication of a specific law but the public policy of postponement or repeal. Numerous discussions have taken place at various levels including nationally and in public print concerning the possibility of repeal or postponement.

As a result of such discussion, entities required to test under section 89 in 1989 tend to procrastinate and avoid the testing procedures until the controversy surrounding the law is settled. Such procrastination is not in the best interest of the entity to be tested under section 89, nor is it in the best interest of the Congress since our tax law is predicated upon voluntary compliance.

Many of my colleagues have not only expressed their opinion that postponement of testing would be appropriate but that the Internal Revenue Service does not administratively have the resources to determine if testing has been done and compliance is therefore met. Therefore, I feel it imperative that Congress settle the controversy pertaining to section 89 and establish that those decisions made some 3 years ago in the Tax Reform Act of 1986 are to be upheld as part of a public policy statement on taxation of U.S. citizens and corporate entities.

For the above reasons, I feel H.R. 1864 is appropriate if not imperative. The Committee on Ways and Means, through this proposed legislation, has established that public policy pertaining to tax law is maintained while at the same time being responsive to the needs of those entities being tested and proposing simplification of section 89.

H.R. 1864 significantly changes the data collection process and the method of testing such that the time necessary to meet the testing requirements under section 89 should be significantly reduced. While time should be reduced in applying H.R. 1864 it does appear that the taxing outcome will shift such that more highly compensated individuals will be taxed on present group-term accident and health plans.

I make this statement since, to avoid taxation on the part of highly compensated individuals, all accident and health plans under H.R. 1864 must be provided to 90 percent of nonhighly compensated employee participants. Under present IRC section 89, an employer meeting the 80-percent test will clearly avoid taxation. On the whole, it does appear that the tighter testing restriction under H.R. 1864 is warranted if simplification and reduced testing expense is the outcome.

Under H.R. 1864 pertaining to excluded employees, we applaud the drafters of this legislation in making more realistic the time-frame and category of those employees which can be excluded from the test. We have seen employers begin to modify their accident and health plans for part-time individuals so that they could meet the old requirements even though the outcome may have been detrimental to the business activities of the entity or to the part-time employee involved. Obviously, 17½ hours under present law is restrictive and the 25-hour requirement under H.R. 1864 is more realistic.

A provision of section 4980C which we feel serves no practical purpose is the imposition of section 4980C(b) to fringe benefits as determined under 4980C(c)(5). Fringe benefit programs providing no additional cost of services for qualified employee discounts are for the most part minimal and not subject to testing under section 89. Rather, they are subject to the qualification requirements reflected under section 4980C under H.R. 1864.

Many employers find that they would not meet the qualification requirements for qualified employee discounts, no additional cost service fringe benefits, or employer operated eating facilities. From a practical standpoint, we find that section 4980C(5) provides no public benefit.

Finally H.R. 1864 is prospective in application since it applies to years beginning after December 31, 1989, but allows employers the opportunity, if enacted, to apply the provisions of H.R. 1864 for years beginning after December 31, 1988. Candidly, we cannot think of many employers that would choose to follow present section 89 given the opportunity to participate in H.R. 1864, and we propose that H.R. 1864 be enacted effective October 1 to allow employers clear determination of what section to apply under.

[The statement of Mr. Gallagher follows:]

PUBLIC COMMENTS PRESENTED BY
CHARLES B. GALLAGHER, JR., CPA
TO THE
COMMITTEE ON WAYS AND MEANS
REGARDING
H.R. 1864

INTRODUCTION

Mr. Chairman and Honorable Members of the Committee on Ways and Means of the House of Representatives, United States Congress, it is my privilege and pleasure to have this opportunity to participate in the public discussion on H.R. 1864. I indeed consider it a privilege and honor to be invited to participate in this occasion and hope that these comments, along with the comments of others, will prove helpful in the speedy passage of H.R. 1864.

As a practicing Certified Public Accountant in North Carolina, member of the American Institute of CPAs and of the North Carolina Association of CPAs and a Certified Public Accountant practicing extensively in the area of employee benefits and executive compensation, I am pleased to see H.R. 1864 being introduced as a substitute for present Internal Revenue Code Section 89. Certainly, the Committee on Ways and Means and specifically Chairman Dan Rostenkowski have shown wisdom in considering simplification of Code Section 89 while retaining the originally conceived tax benefits.

Without restating the obvious, Section 89, as it was originally introduced in the Tax Reform Act of 1986, has undergone various changes and modifications as reflected in 1987 and 1988 technical corrections. As it was originally conceived and subsequently modified, Section 89 reduced, through taxation, the value of tax-free fringe benefits received by highly compensated individuals. While across the country, such benefits may have been significantly discriminatory in application, in the piedmont and western part of North Carolina, we find that discrimination in accident and health plans and/or group term life insurance plans is not rampant.

Obviously, Section 89 in its present form requires complicated testing procedures be done for all accident and health and/or group term life insurance plans or significant penalties on not only the employer but the non-highly compensated employee could occur. As a result, many corporate entities along with employee benefits professionals feel that the administrative responsibility in burden of Section 89 as it presently exist is burdensome.

As a result of the above, many have felt that the repeal or postponement of Code Section 89 was appropriate. I, however, do not share that view. Over the past eight years as our federal tax law has undergone significant change, we feel that Congress must not only look at the tax implication of a specific law but the public policy of postponement or repeal. Numerous discussions have taken place at various levels including nationally and in public print concerning the possibility of repeal or postponment. As a result of such discussion, entities required to test under Code Section 89 in 1989 tend to procrastinate and avoid the testing procedures until the controversy surrounding the law is settled. Such procrastination is not in the best interest of the entity to be tested under Section Code 89 nor is it in the best interest of the Congress since our tax law is predicated upon voluntary compliance. Many of my colleagues have not only expressed their opinion at postponement of testing would be appropriate but that the Internal Revenue Service does not administratively have the resources to determine if testing has been done and compliance is met. Therefore, I feel it imperative that Congress settle the controversy pertaining to Code Section 89 and establish that those decisions made some three years ago in the Tax Reform Act of 1986 are to be upheld as part of a public policy statement on taxation of United States citizens and corporate entities.

For the above reasons, I feel that Code Section 89, as restated in H.R. 1864, is appropriate if not imperative. The Committee on Ways and Means, through this purposed legislation, have established that public policy pertaining to tax law is maintained while at the same time being responsive to the needs of those entities being tested by proposing simplification of Code Section 89.

SPECIFIC COMMENTS

With the above comments in mind, I would like, as part of my testimony, to restate two statements made by Chairman Rostenkowski in his floor statement pertaining to the description of the bill. Chairman Rostenkowski stated, "This bill will not help employers who provide benefits primarily to highly compensated employees and have used arguments of complexity as a smoke screen to hide discriminatory practices." Further, Chairman Rostenkowski stated, "I am strongly and firmly committed to non-discrimination requirements for employee benefit plans. However, these requirements should not be so administratively burdensome on small or large employers that they discourage the establishment and maintenance of fringe benefit programs for broad classes of employees."

The two statements mentioned above, are in and of themselves, appropriate reasons for the passage of H.R. 1864. Many concerns have been expressed relating to the complexity of the present Internal Revenue Code Section 89. Candidly, in our area of piedmont and western North Carolina, we are blessed with substantial numbers of manufacturing concerns which represent small and medium size business on which this country was founded. We are not only represented by traditional business such as furniture and textiles but other manufacturing concerns which focus on high technology such fiber optics and communication. The multiple testing procedures required under present Section 89 require an enormous amount of data in order to accurately compute the discriminatory excess if any for highly compensated individuals. From the prospective of our part of the country, we do not see many highly compensated individuals using complexity as a smoke screen. Rather, we see that compliance can occur at reasonable corporate cost. Obviously, under present Internal Revenue Code Section 89, the time necessary to accumulate the data and calculate the test is significant. Further, it is our opinion, that no test can be done without the assistance of computer programs. Presently, the cheapest program that we have found on the market to test Code Section 89 has been $4,000 and that program limits the test to no more than 100 employees. Other programs which provide unlimited capacity for testing employees range in price from $5,000 to $10,000 per program.

If the above program costs are to be paid by those of us who will provide consultation, advice and testing under Code Section 89, then the cost of time, data accumulation and testing to our clients and those business required to be tested will be significant. Realizing, that I was not present to testify when Code Section 89 was originally adopted, I can not help but believe that Congress did not intend for the cost of the calculation to possibly exceed additional tax generated to the government when highly compensated employees are taxed on their discriminatory excess.

Chairman Rostenkowski's bill, H.R. 1864 significantly changes the data collection process and the method of testing, such that time neccessary to meet the testing requirements under Section 89 should be significantly reduced. While, time should be reduced in applying H.R. 1864, it does appear that the taxing outcome will shift such that more highly compensated individuals will be taxed on present group term accident and health plans. I make this statement since, to avoid taxation on the part of highly compensated individuals, all accident and health plan under H.R. 1864 must be provided to 90% of non-highly compensated participants. Under, present Internal Revenue Code Section 89, an employer meeting the 80% test, will clearly avoid taxation. On the whole, it does appear that the tighter testing restriction under H.R. 1864 is warranted if simplification and reduced testing expense is the outcome.

Under H.R. 1864, pertaining to excluded employees, we applaud the drafters of this legislation in making more realistic the time frame and category of those employees which can be excluded from the test. We have seen employers begin to modify their accident and health plans for part-time individuals so that they met the old requirements eventhough the outcome may have been detrimental to the business activities of the entity or to the part-time employee involved. Obviously, 17 1/2 hours, under present law is restrictive and the 25 hour requirement under H.R. 1864 is more realistic. At the same time we feel it appropriate to retain a provision similar to present Internal Revenue Code Section 89 substituting a shorter period of service, small numbers of hours or months or lower age as specified in a business's plan.

Once again, H.R. 1864, through its addition of Section 4980C, provides a more equitable penalty for failure of a accident and health plan or other, as required, to qualify. Obviously, Section 4980C is intended to replace present Internal

Revenue Code Section 89(k). It would appear that Section 4980C(b) provide essentially the same requirements as current Internal Revenue Code Section 89(k) while significantly modifying the penalty for failure to comply. It is our opinion that such penalty modification is appropriate and a proper statement of public policy.

Present Internal Revenue Code Section 89(k) provides that the value of a benefit received under a plan not meeting the provision of Sectiom 89(k) is taxable to the employee. Such a penalty puts non-highly compensated employees in a position where they could personally suffer for the lack of action of their employer. Section 4980C(a) provides a tax equal to 34% of the amount paid or incurred during a taxable year to the employer. Since the employer is generally responsible for the qualification of and implementation of an accident and health plan or other fringe benefit plan, we feel that it is highly appropriate for the employer to be the one to pay any penalty or tax imposed if such plan is not properly maintained.

Further, we feel that Section 4980C is as important in the administration of H.R. 1864 provisions relating to Section 89 as anything. Therefore, we encourage a simplified method of reporting compliance with Section 4980C such as a specific question asked on business tax returns and signed by the taxpayers under penalties of perjury. Obviously, answering a questions negatively pertaining to Section 4980C or lack of an answer at all may result in further scrutiny by the Internal Revenue Service for compliance not only with Section 4980C but new Section 89.

The only provision of Section 4980C which we feel serves no practical purpose is the imposition of Section 4980C(b) to fringe benefits as defined under Section 4980C(c)(5). Fringe benefits programs providing no additional cost of services for qualified employee discounts are for the most part minimal and not subject to testing under Section 89. Rather, they are subject to the qualification requirments reflected under Section 4980C under H.R. 1864 or present Internal Revenue Code Section 89(k). Many employers may find that they would not meet the qualification requirements for qualified employee discounts, no additional cost of service fring benefits or employer operated eating facilities while meeting the qualification requirements for more structured plans such as accident and health or group term life plans. It appears to be administratively difficult to enforce Section 4980C(b) on these miscellaneous insubstantial employee fringe benefits. For example, if a locally owned clothing store provided that its employees, in the interest of appearance, could purchase clothing at a 10% discount, it is likely that such a policy would not be formerly presented in writing and therefore, could be subject to question concerning legal enforceability. I applaud H.R. 1864, but practically wonder about the public policy or tax benefits generated from imposing these requirements on employers for fringe benefits which, are generally insubstantial. Candidly, the cost of meeting present Section 89(k) or proposed Section 4980C(b) for miscellaneous fringe benefits may be greater than the benefit provided to employees, particularly those in small closely held businesses.

It appears under H.R. 1864, Section 89 that the test to comply with Section 89 shall be based upon the facts and circumstances found on the testing day. If, my interpretation is correct, that means the information necessary to determine compliance with Code Section 89 shall be the information available on the "testing day". In the conference committee reports published under present Internal Revenue Code Section 89, the conferees stated "Under the conference agreement, it is clarified that the test applied to the amount of benefits available or provided must be applied on the basis of the benefits provided during the entire year. Thus, the benefits test, the fifty-percent component of the ninety-precent/fifty-percent test and the comparability test all apply based on the entire year." The conferees went on to indicate a rule of convenience to ease the administrative burden on employers. For those of you who have participate or read the conference report as to the "rule of convenience" those statements are a complicated joke. As such, the significant change established through H.R. 1864 can only be considered refreshing and significantly more simply than present Internal Revenue Service Code Section 89.

Finally, H.R. 1864 is prospective in applications since it applies to years beginning after December 31, 1989 but allows employers the opportunity, if enacted, to apply the provisions of H.R. 1864 for years beginning after December 31, 1988. Candidly, we can not think of many employers that would chose to follow present Internal Revenue Code Section 89 given the opportunity to comply with Section 89 as proposed in H.R. 1864. However, we would point out that benefit professionals, corporations and other entities performing tests under present Internal Revenue Code Section 89 must continue to be familiar with present law and proposed regulations along with H.R. 1864 so as to properly advise and conduct testing under Section 89. While it may not be feasible, we feel that swift action and passage of H.R. 1864 would be in the best interest of those applying the provisions of Internal Revenue Code Section 89 for calendar year 1989. Further, if it would be possible to require the provisions of proposed Code Section 89 under H.R. 1864 for all plans tested after September 30, 1989, we feel the cause of simplification and clarification would be met.

While many entities may be wrestling with Section 89 or considering testing under present Internal Revenue Code Section 89 during the summer of 1989, we feel that clear communication to U.S. taxpayers concerning the approval of and implementation of H.R. 1864 is entirely appropriate. In addition to the above, we hope that regulations required to be submitted no later than six months after the date of enactment of H.R. 1864 will be issued on a timely basis. The fact that the Internal Revenue Service has proposed regulations on the table concerning Section 89 at this time should enable them to modify those regulations to comply with H.R. 1864 in a short period of time and should be directed by the administration to give such a proposal upmost priority.

CONCLUSION

Again, we appreciate the invitation issued by the Committee on Ways and Means to participate in testimony pertaining to H.R. 1864, SIMPLIFICATION OF SECTION 89, INTERNAL REVENUE CODE. The public policy statement made by this legislation establishes the firm intention of Congress to allow employee benefits to be provided on a substantially non-discriminatory basis while at the same time simplifing the application of testing related thereto. We feel the Committee should recognize even with H.R. 1864 and the resulting simplification, all employee benefit plans defined in proposed Section 4980C(c) must meet those qualification requirments and accident and health plans must meet the provisions of proposed Section 89 including the determination of benefit value for those plans. Based on the above, employers adopting and maintaining accident and health plans will clearly have administrative cost extended to their own staff or others to meet the requirments of Section 89, if in no other way through the valuation of benefits and compliance under proposed Section 4980C. Such administrative burdens and costs will be substantially reduced under H.R. 1864 as compared to the estimate of those costs under present Internal Revenue Code Section 89. In Chairman Rostenkowski's earlier statement concerning requirements discouraging establishment and maintenance of fringe benefit programs, we feel that H.R. 1864 will not adversely affect present programs or the consideration of future programs for employees in fact, the simplification reflected through H.R. 1864 should nudge employers toward providing less discriminatory plans.

Most important in the adoption of H.R. 1864 as introduced in the House on April 13, 1989, should be the expeditious adoption of this Section. Clearly consideration in complication reflected through multi-employer plans, separate lines of business exceptions, treatment of union employees, acquisition and disposition rules, coordination of medicare and least employees safe harbor provisions all require consideration and are complicated. However, the positive modification reflected through H.R. 1864 more than offsets the fact that Section 89 is still a complicated piece of legislation for certain types of business which by their nature are complicated. Significant modification to H.R. 1864 Section 89 provisions and thus unnecessary delays will continue to foster the assumption that Internal Revenue Code Section 89 may be repealed or postponed and thus testing should be postponed until the last possible minute. Again, we applaud Chairman Rostenkowski for his willingness to follow tax policy and at the same time respond to the enormous needs of those who are required to comply with Section 89. We hope that this vote of confidence and the suggestions contained herein both support the present provisions of H.R. 1864 and encourage lawmakers to speed forth the adoption thereof.

Mr. JENKINS. Thank you, Mr. Gallagher.
Mr. Peacock.

STATEMENT OF EDWIN B. PEACOCK, JR., PRESIDENT, POMFRET FINANCIAL CO., CHARLOTTE, NC

Mr. PEACOCK. Thank you very much. I would like to depart briefly from my prepared text to introduce three people who are my associates. Pierce Ward from Charlotte, NC; Tom Luss from Southampton, NY; and Kenneth B. Hodge from Newport News, VA.

Thank you for the opportunity to appear today. My name is Ed Peacock. I am the president of the Pomfret Financial Co. We are a life insurance brokerage firm, and we work with important U.S. corporations. We specialize in the design, installation, and administration of employee benefit programs.

I am not speaking for the insurance companies that Pomfret Financial represents or for any of our customers or prospects. I am only speaking from my personal observations while working with large insurance companies and a number of U.S. corporations.

My comments, unlike all of the other speakers for the last 2 days, are in reference to the group term life insurance provisions of H.R. 1864 and section 89 and/or section 79 which govern group term life insurance. H.R. 1864 transfers most responsibility back to section 79 for discriminatory group term life insurance plans.

Two suggestions you may want to consider are: one, section 89 has a $200,000 limit on covered pay for compensation based group term life insurance plans. If compensation over $200,000 is included, then under section 89 the benefits are discriminatory. This provision of the law is not in section 79. You may want to retain it in section 89 or amend section 79, as appropriate. This will make group term life insurance compensation limits consistent with other law governing pension and profit sharing plans.

Also, if the $200,000 pay limit on section 89 or section 79, employers will be more inclined to adjust benefits for the rank and file employees so that highly compensated employees are not adversely affected by penalties for discrimination. In order for the bill to work, you have to have some easily measurable penalty to the highly compensated. Both section 89 and section 79 contain a provision that highly paid employees in discriminatory group plans will have taxable income equal to the greater of section 79, table I or actual cost. This language permits avoidance of the intent of the law. In fact, as the law was originally written in 1983, a highly paid employee who participated in a discriminatory plan could have taxable income based on actual cost rather than the greater of section 79, table I or actual cost.

Section 79 was later amended when it became evident that actual cost for some companies was less than table I. Before the law was changed in 1986, companies were inadvertently encouraged by the law to establish or retain discriminatory plans.

Under any circumstances, actual cost is very difficult, if not impossible, for the IRS to accurately define. The definition of actual cost will be very different from company to company and from industry to industry. There will almost certainly be endless debates about what is actual cost.

The Ways and Means Committee may want to consider changing the penalty for discrimination from the greater of table I or actual cost. In its place, use an IRS table of values for life insurance benefits called PS-58 rates. Perhaps as an alternative to the PS-58 table, you may want to use 150 percent of section 79, table I rates.

I will not read it into the record, but as a part of my testimony example which is attached to my written report which will show the various alternatives that you may want to consider.

If the law for group term plans is easy to understand and has easy to understand consequences for discrimination, then Congress will: one, promote broad-based nondiscriminatory group term life plans; two, enhance revenue for the Government; and three, greatly simplify section 89 and/or section 79.

The Internal Revenue Service will more easily be able to define discriminatory plans and the subsequent penalties; be able to more quickly finalize regulations; and find a higher level of voluntary compliance from taxpayers.

From a taxpayer's viewpoint, they will be able to more easily determine if their plan is in compliance; measure the economic consequences to highly paid employees of discriminatory group life plans; and if necessary, adjust their group plans.

Insurance companies will be able to develop prototypes to meet the requirements of the law, and this is a very important part of the medical aspects of this proposed law; they will not be under pressure from important customers to determine a favorable actual cost; and they will not be confronted with companies shopping opinions to find the lowest actual cost.

I thank you very much for your consideration.

[The statement and attachment follow:]

To: The Honorable Chairman Dan Rostenowski & Members
Committee on Ways and Means
U. S. House of Representatives

From: Edwin B. Peacock, Jr., CLU, President
The Pomfret Financial Company
200 Queens Road
P. O. Box 30457
Charlotte, NC 28230-0457

Phone: 704-373-1833

Subject: May 2 and 3, 1989 - Public Hearing on H.R. 1864

Thank you for the opportunity to appear today. My name is Ed Peacock. The Pomfret Financial Company is a life insurance brokerage firm and works with important United States corporations. We specialize in the design, installation, and administration of employee benefit programs.

I am not speaking for any of the insurance companies that Pomfret Finanical represents or for any of our customers or prospects. I am only speaking from my personal observations while working with large insurance companies and a number of United States corporations.

My comments are in reference to the group term life insurance provisions of H.R. 1864 and Section 89 and/or Section 79. H.R. 1864 transfers most responsibility back to Section 79 for discriminatory group term life insurance plans. Two suggestions you may want to consider are:

(1) Section 89 has a $200,000 limit on covered pay for compensation based group term life insurance plans. If compensation over $200,000 is included, then under Section 89 the benefits are discriminatory. This provision of the law is not in Section 79. You may want to retain it in Section 89 or amend Section 79, as appropriate. This will make group term life compensation limits consistent with other law covering pension and profit sharing plans.

Also, if the $200,000 pay limit is included in Section 89 or Section 79, employers will be more inclined to adjust benefits for rank and file employees so that highly compensated employees are not adversely affected by penalties for discrimination.

(2) Both Section 89 and Section 79 contain a provision that highly paid employees in a discriminatory group term life insurance plan will have "taxable income equal to the greater of Section 79-Table I or actual cost." This language permits avoidance of the intent of the law.

In fact, as the law was originally written in 1983, a highly paid employee who participated in a discriminatory plan would have taxable income based on "actual cost" rather than "the greater of Section 79 -

Table I or actual cost." Section 79 was later amended when it became evident that "actual cost" for some companies was less than Section 79 - Table I. Before the law was changed in 1986, companies were encouraged by the law to establish or retain discriminatory plans.

Under any circumstances, "actual cost" is very difficult (if not impossible) for the IRS to accurately define. The definition of "actual cost" will be very different from company to company. There will almost certainly be endless debates about "actual cost."

The Ways & Means Committee may want to consider changing the penalty for discrimination from "the greater of Table I or actual cost" and in its place use an IRS table of values for life insurance benefits called PS-58 rates. Perhaps as an alternative to the PS-58 table, you may want to use 150% of Section 79 - Table I rates.

On the next page is an example of the effect at various ages of these suggestions.

If the law for group term life plans is easy to understand and has easy to understand consequences for discrimination; then,

Congress will:

(1) Promote broad based non-discriminatory group term life plans.

(2) Enhance revenue for the U. S. Government.

(3) Greatly simplify Section 89 and/or Section 79.

IRS will:

(1) More easily be able to define discriminatory plans and the subsequent penalties.

(2) Be able to more quickly finalize regulations.

(3) Find a higher level of voluntary compliance from taxpayers.

Taxpayers (corporate & individuals) will:

(1) More easily determine if their plan is in compliance.

(2) Measure the economic consequences to highly paid employees of discriminatory group term life insurance.

(3) Adjust their group term life plans, if necessary.

Insurance companies will:

(1) Be able to develop prototype plans to meet the requirements of the law.

(2) Not be under pressure from important customers to determine a favorable "actual cost."

(3) Not be confronted with companies "shopping opinions" to find the lowest "actual cost."

Thank you for your courteous consideration!

Example of Taxable Income
For an
Employee with
$500,000 Group Term Life Insurance

Age	(1) Executive's Taxable income Under Non-Discriminatory Section 79	(2) Executive's Taxable Income Under Discriminatory Section 79 * H.R.-1864	(3) Executive's Taxable Income with Discriminatory Section 79 using 150% of Table I Rates	(4) Executive's Taxable Income With Discriminatory Section 79 using PS-58 Rates
45	$1,566	$1,740	$ 2,610	$ 3,150
50	2,592	2,880	4,320	4,610
55	4,050	4,500	6,750	6,870
60	6,318	7,020	10,530	10,365

*Presumes "actual cost" is less than Section 79 - Table I.

The Pomfret Financial Company, Inc.

Mr. **Jenkins**. Thank you very much for your testimony. I think we are about out of time because we have a vote on the House floor, but I will yield to Mr. Anthony.

Mr. **Anthony**. Thank you, Mr. Chairman. I just wanted to thank this panel. I think you have made some very outstanding specific technical suggestions that the committee and the staff ought to take a very, very close look at. I am especially, Ms. Hevener, interested in going back over your dependent child care section to make sure that we do not create disincentives in Section 89 for that very important section.

But I think you have made a very valuable contribution to this record and I want to thank you. I am sorry we do not have more time to go into a lot of the details of your testimony.

Mr. **Jenkins**. Thank you very much for your testimony. The committee stands in adjournment.

[Whereupon, at 12:12 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF

THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association is pleased to have this opportunity to submit a statement on Section 89 of the Internal Revenue Code and its impact on the banking industry. The American Bankers Association is the national trade and professional association for America's commercial banks of all sizes and types. Assets of ABA member banks are approximately 95 percent of the industry total. ABA represents the majority of community banks in the United States whose assets average up to $250 million. Most of our members have an employee base of fewer than 50 employees.

Beginning this year, virtually all employers will be forced to bring their group term life insurance, health and other welfare benefits plans into compliance with the complex requirements imposed under Section 89 of the Internal Revenue Code. The goal of Section 89, a new Section of the Tax Code added as a result of the Tax Reform Act of 1986, is to insure that benefits programs are provided on a nondiscriminatory basis to all employees. Further expansion of the nondiscrimination "test" was provided as a part of the Technical and Miscellaneous Revenue Act of 1988. IRS regulations released on March 7, 1989 added another level of complexity to the tests.

The requirements of Section 89 are separated into two sets of rules: those relating to the qualification standards and those relating to the new non-discrimination rules. In addition to five basic qualification rules for Section 89, every benefit plan must pass an additional complex set of mechanical nondiscrimination tests. The nondiscrimination rules of Section 89 are comprehensive and could have a dramatic effect on an employee's tax liability and also on an employer's benefit costs.

Because of the complexity of the rules and the amount and variety of the information required to comply with Section 89, employers sought legislative relief from compliance with Section 89. Responding to a clamor for relief from the business community, several bills were introduced to repeal, delay or amend Section 89.

The American Bankers Association commends the efforts of the Chairman and members of the Committee on Ways and Means to simplify Section 89 of the Internal Revenue Code through the introduction of H.R. 1864. H.R. 1864 would significantly simplify the testing procedures in Section 89 today. The bill replaces the current Section 89 nondiscrimination rules with a single simplified test. It would also increase the number of hours required to qualify as a part-time employee from 17.5 to 25.

We believe that this bill is a positive move that simplifies Section 89 and is a step in the right direction. There are, however, some concerns that we believe H.R. 1864 does not adequately resolve. Our statement addresses these points. We urge all Members of this Committee to include additional provisions which will enable businesses to better comply with Section 89. ABA recommends that final legislation on Section 89 contain the following provisions:

* That part-time employees be redefined as employees working 30 hours a week for testing purposes.

* Exclusion and separate testing of certain categories of employees in applying the nondiscrimination tests.

* That the effective date for compliance with Section 89 be changed from January 1, 1989 to 12 months after issuance of final regulations.

* That employers be given the option of using either present law or the new rules for compliance for 1989 and 1990.

* That legislation on Section 89 contain a requirement that Treasury not enforce current regulations on Section 89 pending legislative action. (While Treasury postponed the effective date of current regulations for three months, from July 1, 1989 to October 1, 1989, it could be considerably longer before new legislation is drafted and new regulations promulgated).

Employers have traditionally been free to design health and group life insurance plans that reflect the size and needs of their workforce, their geographic location and the requirements of the industry to retain employees. Consequently, employer-sponsored health plans have flourished and more employees are covered than ever before. The goal of Section 89 was to provide health care for the estimated 30-40 million Americans who are otherwise unable to afford health care coverage. However, in implementation, it has proven too complex to administer. It has had a negative impact on businesses that offer employer-sponsored health and welfare benefits.

For example, some banks have considered cutting back or dropping employer-sponsor health plans. A community bank in Waseca, Minnesota, with assets of $51 million is located in a rural community and has a staff of approximately 23, including the janitorial staff. This community bank is in the process of making the difficult decision of whether to spend a considerable amount of money to test their plans under Section 89, or to drop their benefit plans for all employees and to boost the income of each employee to enable employees of the bank to buy their own health insurance. The bank's management is concerned that the employees may choose to use this "bonus" for purposes other than the purchase of health insurance. This bank is just one community bank in the country, but it is representative of the hundreds of community banks facing the difficult issue of compliance with Section 89 as it is currently written. They simply do not have the funds to hire experts in the health field, attorneys to interpret the emerging law or insurance experts to administer plans.

90 Percent Eligibility Test
And the Separate Testing of Excluded Employees

The principal complicating feature of Section 89 today is the numerous percentage tests for eligibility and benefits which the employer must meet to avoid the income tax sanctions.

Currently, Section 89 states that certain employees can be tested separately to determine if the employer's plan is in compliance with Section 89 generally. This "separate testing rule" was contained in the original legislation to mitigate the harsh effect of the all-or-nothing exclusion in Section 89 for certain groups of employees--i.e. part-time employees, those not completing six months of service or employees under age 21.

H.R. 1864 proposes to simplify Section 89 compliance by substituting the numerous non-discrimination tests with one test requiring that 90 percent of all non-highly compensated employees be eligible for core coverage. The "separate testing rule" exception, however, was not carried over into H.R. 1864. As presently drafted, H.R. 1864 deletes the "separate testing" provision (subsection (h)(5)) from Section 89 and precludes businesses from separately testing probationary and part-time employees. We urge that this separate testing approach be retained. The separate testing rule is necessary because it allows the nondiscrimination rules to be met while providing coverage for all full-time employees and some part-time employees as well.

The 90% threshold in H.R. 1864, when combined with the elimination of the "separate testing rule", makes it virtually impossible for employers that offer broad-based health plans to meet such a high standard.

For example, a bank has 84% of their full-time salaried employees whom are eligible for health insurance coverage; 11% of their employees work 17 1/2 hours or less and are ineligible for benefits; and 5% work less than 17 1/2 hours but receive health benefits under the employer-sponsored plan. If this bank tested their benefit plan under Section 89 today, which has the "separate testing rule", this bank will pass the non-discrimination test. It can only do so because it is allowed to exclude from the testing pool, employees that work 17 1/2 hours or less and who are otherwise ineligible for health coverage. But if the "separate testing rule" were to be eliminated from Section 89 testing, as H.R. 1864 proposes to do, the bank would fail the 90 percent eligibility test. Under the proposed legislation, of the employees eligible to receive employer-sponsored benefits, only 89% would be eligible for coverage (84% + 5% = 89%) falling just short of the 90% threshold called for in H.R. 1864. Several banks in the country have this exact problem.

Without retention of the "separate testing rule", an employer who might otherwise satisfy the 90% eligibility test, might be motivated to reduce the number of eligible employees in an attempt to meet the 90% non-discrimination test. One method to lower the number of eligible employees is to drop employer-provided benefits for part-time or probationary employees.

We urge that H.R. 1864 be amended to preserve the "separate testing rule". For without it, H.R. 1864 would discourage employers who provide above average fringe benefit programs for all employees.

Part-time Employees

Under Section 89 today, part-time employees, defined as working up to 17.5 hours, must be included in calculations for discrimination testing. H.R. 1864 changes the definition of a part-time employee to 25 hours. This change helps, but it still ignores the current market realities in health care and small business in which the definition of part-time employment is a 30 hour work week. In addition, benefits available to employees reflect regional or geographic practices. In many parts of the country, insurance companies will not sell health insurance for employees who work less than 30 hours per week. We believe that redefining part-time employees to those working 30 hours is more appropriate.

Effective Date

Implementation of any changes to Section 89 should be delayed, at a minimum, for at least 12 months after enactment. Additional time is necessary to allow businesses time to redesign plans in order to pass the Section 89 test. The process of testing all plans, redesigning plans to comply with Section 89 nondiscrimination rules, followed by retesting, will take months to effectuate. Delaying the effective date of Section 89's nondiscrimination testing to 12 months after final regulations are promulgated by IRS will provide businesses the necessary time to comply with Section 89. In addition, we urge Members of the Ways and Means Committee to sponsor and support legislative initiatives requiring that Treasury withdraw the proposed regulations on Section 89 until legislative relief is provided by Congress. It is counterproductive to pay consultants' fees and programming costs to comply with Section 89 only to have the law extensively modified months later.

CONCLUSION

The banking industry is committed to providing adequate and uniform health and insurance coverage for their employees. We agree that, as a matter of public policy, employees should receive equitable benefits. However, because Section 89 is extremely complex, and because the regulations are an administrative nightmare, it has become a tremendous disincentive for employers who maintain health and life insurance for their employees. Many consultants are recommending that employers terminate their health and life insurance plans, give their employees a bonus, and simply have employees buy health coverage on their own. On costs, the Kansas Bankers Association has estimated that the cost to Kansas banks of compliance with Section 89 and the current regulations would be nearly one-half million dollars.

Making compliance easier is an important direction for Congress to proceed in developing alternatives to Section 89's requirements. However, the provisions of H.R. 1864 that impact on Section 89 do not go far enough in providing the needed relief business requires to make certain that disincentives do not persist for the provision of health and insurance coverage to employees. Public policy must be pursued in ways that acknowledge the limitations of the business community and their ability to comply. To that end, ABA has supported repeal of Section 89 because we see little benefit to phasing in rules which will only lead to costly adjustments.

Unless significant improvements can be made in the design of these requirements to minimize the complexity and paperwork burden of subsequent regulations, Congress should still consider repealing Section 89 and starting over.

HEARING ON SECTION 89 AND H.R. 1864

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Statement of the Section of Taxation of the American Bar Association

This statement reflects the views of the Section of Taxation of the American Bar Association. It has not been approved by the American Bar Association and accordingly should not be construed as representing the position of the Association.

A. Summary and Conclusions

1. H.R. 1864 is a major step in the right direction and significantly simplifies current law. Additional simplification could be achieved without undermining the tax policy underlying existing section 89.

H.R. 1864 eliminates significant amounts of complexity in existing law, such as complex aggregation rules that apply differently with respect to different tests, the necessity of collecting employee-by-employee data with respect to non-highly compensated employees, testing based on plan design as opposed to the actual value of coverage provided on an employee-by-employee basis, the elimination of different tests for different purposes, and, in many cases, alternative tests available with respect to the same requirement.

However, H.R. 1864 could achieve significantly greater simplification by providing that the value of benefits should be determined based on premiums paid or cost incurred in a prior year as opposed to the current year, by providing for testing for nondiscrimination on an averaging rather than an employee-by-employee basis, by providing employers with the option of using the same testing approach for all welfare benefits, by identifying part-time employees based on the hours they are regularly scheduled to work rather than the hours actually worked, and by eliminating the burden of an acquiring company seeking to take advantage of the controlled-group transition rules from having to obtain and examine data relating to the plans of acquired companies prior to their acquisition.

2. H.R. 1864 relies too heavily upon the development and promulgation of difficult and complex regulations for implementation and sets an unrealistic 6-month time deadline.

The bill would become effective in 1990 and require that regulations be promulgated within six months. Without greater statutory specificity to eliminate conflicts and gaps between broad concepts embraced by the bill, it is unreasonable to expect fair, comprehensive regulations to be adopted on this time schedule. Additional consideration should be given to further simplifying and reconciling the principal statutory rules to avoid creating a regulatory regime as problematic as that which already exists.

To deal with the period prior to the time that regulations can be issued and employers can adjust to such regulations, simple transition rules should be developed that can be understood and administered on the basis of the statutory language alone.

3. H.R. 1864 contains many improvements over existing section 89, but it continues other defects and introduces new defects into this area.

H.R 1864 is a significant improvement over current law in many respects. For example, H.R 1864 would shift nondiscrimination testing from the actual testing of coverage provided employees to testing based on plan design. The bill would increase the hours threshold for part-time employees that cannot be excluded from the testing process, and provide for separate testing of employees covered by collective bargaining units.

However, H.R. 1864 continues some of the defects of existing law. For example, the bill would require the Treasury Department to develop tables to be used for purposes of valuing coverage under health and accident plans. No new rules would be provided relating to leased employees which eliminate abuse without unnecessary complexity in testing. The bill also fails to identify part-time workers based on the hours individuals are regularly scheduled to work as opposed to the hours actually worked. Significant terms, such as "core benefit," are not defined. The bill would eliminate the option afforded employers under current law to test virtually all welfare plan benefits on the basis of a uniform set of rules as opposed to separate rules applicable to each type of benefit. The bill would also provide disparate treatment of benefits attributable to salary reduction, and impose a new 34% penalty for employers who fail to comply with the qualification rules of section 89(k) without regard to good faith attempts at compliance and without regard to the extent to which the rules have been violated. Further, the bill would use a definition of "highly compensated employee" which is different from the definition used with respect to other types of benefits subject to nondiscrimination rules.

4. It is questionable whether H.R. 1864 will achieve one of the stated purposes underlying existing section 89, i.e., increasing health coverage among employees who are not highly compensated.

Like current law, H.R. 1864 permits employers to violate its nondiscrimination rules as long as highly compensated employees have additional income reported on their Forms W-2. H.R. 1864 should prevent the use of the average American's tax dollars from subsidizing the cost of health plans maintained for executives through the effective elimination of tax subsidies associated with highly compensated employees covered by discriminatory health and accident plans. However, the bill does not provide an incentive to increase health coverage among non-highly compensated employees.

B. Analysis

H.R. 1864, sponsored by Ways and Means Committee Chairman Rostenkowski (and 29 other House members) was introduced on April 13, 1989. It would revamp the welfare plan nondiscrimination tests of Section 89 of the Internal Revenue Code and revise the penalty for violations of the qualification requirements of Section 89(k). The stated goal of H.R. 1864 is to simplify the nondiscrimination rules and eliminate unnecessary data gathering and testing, without sacrificing the asserted social policy objectives of Section 89: increasing health coverage among rank-and-file employees who otherwise would not purchase or could not afford such coverage and assuring that the highly compensated do not receive tax-favored benefits under accident and health programs that disproportionately benefit such persons. As a practical matter, the bill is a response to those who seek to repeal or delay the effective date of Section 89. As it constitutes the approach favored by the Ways and Means Committee Chairman, the bill must be regarded as the leading piece of proposed Section 89-related legislation.

There will be a hearing in the House on May 2, 1989, with respect to the bill. There have yet to be any revenue estimates issued in connection with the bill, but it is generally expected to produce less than the previously predicted $550 million increase in revenue anticipated under Section 89.

The more attractive features of H.R. 1864 relate to the repeal of testing, calculation, comparability and participation rules. In fact, while these rules have been simplified by the bill, many complex compliance issues remain.

H.R. 1864 establishes as a threshold for any exclusion for health coverage for the highly compensated a requirement that an employer make "affordable " health coverage available to at least 90 percent of its non-highly compensated employees. This is defined as a plan (or combination of plans) offering primarily core health coverage for the employee that costs the employee no more than $10 per week in pre-tax or post-tax contributions. The $10 figure is indexed to wage inflation and is $25 per week (adjusted for wage inflation) for family coverage.

If a plan meets that standard, the value of each highly compensated employee's total health coverage is excludable from income to the extent it is worth no more than 133 percent of the value of the lowest-value affordable health plan that is available to at least 90 percent of the non-highly compensated. For this purpose, benefits of highly compensated employees with family coverage are compared with the highest value employee-plus-dependent primarily-core health coverage available to at least 90 percent of the non-highly compensated that costs the employee no more than $25 per week (indexed to wage inflation). Also, in applying this test salary-reduction, contributions are treated as employer-provided for the highly compensated, but employee-paid for the others. The effect of this differential is to lower tax-excluded amounts for the highly compensated.

Other Section 89 changes would be:

-- The level for excluding part-timers would be raised from 17.5 to 25 hours per week;

-- Union-represented employees would be tested separately;

-- Section 89 would apply solely to health and accident coverage, as Section 79(d) would be restored for testing group-term life and dependent care assistance would be tested solely under Section 129;

-- Leased employees could be disregarded if they constitute less than 20 percent of the workforce and the leasing organization offers them an affordable health plan;

-- Section 89 testing for former employees would be postponed to 1990;

-- Employers with no one making more than 50 percent of the defined benefit Section 415 limit (i.e., more than about $49,000 for 1989) would have no highly compensated employees for purposes of Section 89;

-- Employers could choose not to test and, instead, include the full value of highly compensated employees' health coverage in their income; and

-- The current income tax sanction on employees for violation of Section 89(k) would be replaced by an excise tax on employers equal to 34 percent of their health coverage expenses for the year of the violation.

Advantages of H.R. 1864 Over Current Law

Design-Based Testing. Employers that offer essentially the same health coverage options to all employees would have to do virtually no actual testing, if they assure that each of the plans stay within the $10/$25 weekly contribution limits that characterize an "affordable" plan. Thus, for many employers, particularly small ones with relatively simple plans, the administrative burden of the Section 89 non-discrimination rules would be eliminated. Plan design changes will, however, have to be made to many, if not most, contributory plans to fit within these limits. For sponsors with many plans, simplification is only partial.

Paperwork Reduction. In the significant number of cases where testing would still be required (e.g., where not all options meet the affordability criteria, or different plans are offered to different employee groups) the bill would still eliminate the employee-by-employee data gathering with respect to non-highly compensated employees that is needed to measure actual coverage against the discrimination tests under current law. The tests are simpler, although the streamlining promised by the legislation is likely exaggerated.

Restoration of Section 79(d). The Section 89 non-discrimination test have never made sense for group term life insurance. The inconclusive tinkering undertaken in connection with TAMRA shows that restoration of Section 79(d) is the only appropriate response. Note that those tests would in fact be tightened, as the classes of employees that could be excluded in applying them would be the same as under Section 89.

Raising the Part-Time Cutoff. Adopting a 25-hour standard to identify excludable part-timers makes it much easier for many more employers to pass the test based on plan design alone.

Leased Employees. Adding a safe-harbor exclusion rule comparable to that for retirement plans eliminates the leased employee problem for many employers. In many industries, however, the threshold of the safe-harbor is too low to solve the problem. It will still be difficulty to identify a sponsor's "leased employees" in many instances.

Separate Testing for Bargaining-Unit Employees. Separate testing for bargaining-unit employees, if appropriately interpreted, would eliminate the undue intrusion of tax considerations in the labor-management relations process. It also should greatly streamline the application of Section 89 in multiemployer situations.

As the above indicates, H.R. 1864 represents a thoughtful and creative approach to the challenge of streamlining Section 89. Thus, it merits serious study as the basis foundation for what could be an improved law.

Issues Raised by H.R. 1864

More Taxable Coverage. The overall impact of the revised tests will likely be increased taxes on highly compensated employees' income attributable to health coverage, when compared to what the current law would produce. In most cases, this is because complicated rules and procedures to measure discrimination more precisely would be eliminated in the name of simplification. The key policy question is whether the line can be drawn more equitably without sacrificing too much of the administrative streamlining the bill offers.

Lowest Common Denominator Effect. Under existing law, the 75 percent test comparing actual coverage of the highly paid with the coverage of others is based on averages. Under the bill the comparison would be performed separately for each highly compensated employee, thus eliminating the averaging effect for that branch of the test. It would be compared to the smallest employer-provided benefit available to 90 percent of the non-highly compensated, thus eliminating much of the averaging on that end as well. The maximum tax favored benefit for a highly compensated person is 133 percent of this benefit (apparently, it should be noted, as the proposed statute and official commentary are not altogether consistent on this point). This rule will generate much of the additional tax anticipated under the bill.

Exacerbated Cliff. Under current law, if an employer cannot meet the 80 percent coverage test it must offer health coverage to 90 percent of the non-highly compensated or its highly compensated employees will be taxed on the full value of their health coverage. The impact is the same whether 85 percent or 15 percent of the non-highly compensated employees are eligible for some coverage. However, the tax impact is moderated if the value of the coverage available to the 90 percent is too low. Under H.R. 1864 the cliff effect is exacerbated rather than relieved: the highly compensated would be fully taxed on their health coverage if less than 90 percent of the non-highly compensated are eligible for health coverage, or if it is offered to them but costs more than $10 per week for individual coverage. Many employers, including many in the public sector, with broad-based and widely used health plans would fail this test.

An employer, such as a school district, with a broadly based plan that costs more than the bill's affordability standards could only preserve some share of its highly compensated employees' tax exclusion by adopting a cheaper alternative plan. The actual cost of this approach would unquestionably outweigh the cost of current law discrimination testing.

Impact on Flexible Benefits Plans. The current law and proposed regulations addressing salary-reduction under Section 89 are complex but appear to approximate an equitable solution to a highly sophisticated problem. The bill is simple but dramatically harsh in its effect on health plans that allow employees a cash option (and possibly even those in which all of the choices are non-taxable benefits). This approach is justified by proponents on the basis that Congress has intended all along to reduce the benefit derived by the highly compensated through flexible spending accounts. Without regard to policy considerations, the disparate treatment of earnings reduction contributions is confusing and adds an additional level of complexity to an already extremely complicated area.

Further Observations and Recommendations

Eliminate the Cliff. Either through a sliding-scale of includability or through a revision of the 90 percent $10/$25 rule, the cliff penalty should be leveled. One problem with the proposed rule, as with the current law's 90 percent/50 percent test, is that it is overly ambitious. Section 89 will not and cannot effectively substitute for universal minimum standards legislation, because the cost to the employer of compensating highly compensated employees for the tax on their benefits will always be less than the cost of expanding coverage. Unless the Congress has concluded that the Rostenkowski proposal will accomplish legitimate policy goals and can be lived with for a sufficient time to justify compliance cost, the new rules perhaps should not be adopted at this time.

Test Based on Averages. Little more data would be needed to determine the average value of the affordable core benefits available to 90 percent of the non-highly compensated. This value could easily be used in the 133 percent test applied to the highly compensated. Similarly, each highly compensated employee's actual benefit would have to be determined in order to apply the 133 percent test. This is unnecessary and complex. An average benefit test also should be used here. Note: this would facilitate the restoration of an important TAMRA concept: one-day-a-year testing for highly compensated employees.

Actual Coverage Alternative. Employers that wish to demonstrate nondiscrimination based on actual coverage should be allowed to do so even if they do not offer an "affordable" plan to 90 percent of the non-highly compensated. This could be done using streamlined standards comparable to those of H.R. 1864's availability tests.

Flexible Benefits. By their nature cafeteria plans require more data gathering and administration than other types of health plans. Presumably sponsors of such plans would be willing to apply suitable anti-abuse rules designed for bona fide choice plans, rather than giving them up altogether, as may well be the outcome under H.R. 1864.

Leased Employees. The inclusion of leased employees should be deferred until there is some clarification as to what a "leased employee" is. Short of that, the proposed safe harbor in H.R. 1864 would be a major improvement over current law if it were accompanied by legislative history expressly disavowing the proposed regulation under Section 414(n) as overbroad and calling for good-faith identification of leased employees under the statute and legislative history, in light of the specific anti-abuse concerns that led to enactment of Section 414(n).

Former Employees. The bill would postpone testing of former employees for a year, because no one has any notion of how it should be done. This is clearly not a policy priority. It should be postponed to the later of a year or the first plan year beginning six months after issuance of final regulations on the subject.

Part-Timers. It is understood that most major insurers will not cover part-timers working less than 30 hours a week for small groups (e.g., those under 25). Thus, if a sponsor employs any significant number of people for less than 25 hours a week, it could not offer nondiscriminatory plans even if it wished to. It would be appropriate to phase in the part-time rule, perhaps at 30 hours this year, 27-1/2 the next and 25 the next, to give the insurance market time to adjust. At a minimum, this phase-in should at least be preserved for employers of ten and under, for whom such a rule was added last year by TAMRA (but dropped by H.R. 1864).

Also, part-timers should be identifiable based on the hours they are regularly scheduled to work, rather than requiring specific tracing of hours. An anti-abuse override could be included where there is a clear divergence between the stated number of scheduled hours and the actual hours worked on a consistent basis.

Reporting Income. H.R. 1864 gives employers the explicit option of including all of a highly compensated employees's health benefit as income rather than testing. This suggests that this alternative is not an option under current law. The legislative history should make clear that the Internal Revenue Code does not prevent an employer from including amounts in income that might be excludable, i.e., it does not create an obligation on the employer to maximize its employees' income exclusion opportunities. The law and/or legislative history should make it clear that to the extent employers are offered alternative ways to meet the non-discrimination test, they can choose any of them and report income on that basis. Employers should not be required to apply them all in order to find the best alternatives for each employee or for the government.

Section for Section 89(k) Violation. H.R. 1864 would impose a flat 34 percent excise tax on employers that have an 89(k) violation in a year (tantamount to the original CORBA sanction). The 89(k) penalty should be redirected to the plan sponsor and not to employees, and should be revised along the lines of last year's revision to the COBRA penalties to encourage quick correction of good faith errors, etc. Clearly, the suggested penalty will often be out of line with the abuse. Perhaps it would be possible to link the Section 89(k) penalty directly to the COBRA sanction and thereby avoid another Code section.

Effective Date. The proposed changes create a real crisis of conscience: what kind of signal is being sent to employers that took Section 89 seriously and invested heavily in compliance? Perhaps one way to deal with this issue would be to allow employers the free option to continue to use current law (perhaps with some streamlining, such as the 25-hour test for part-timers) for five years. Many employers have already made significant expenditures for Section 89 compliance. The proposed changes are effective in 1990 (with an option for 1989 allowing use of either H.R. 1864 standards or current law). Given the present chaotic state of law in this area, surely a strong case can be made in favor of the proposition that no Section 89-type legislation should be effective in 1989. Indeed, a better course would be to defer the application of Section 89 until a well thought out and coordinated solution can be implemented. The bar must implore the Congress to stop the quick-fix process that has become the norm with continued technical corrections and further tinkering. The current process is not simple, fair or equitable. Employers need time to make the level of changes that would be required--after regulations are out. The Section 89 rules should be suspended until then.

Core Benefits. Once again, we have a statute that does not define one of its most critical terms--core benefits. Leaving this to the regulators is unfortunate and unacceptable from a policy perspective. If employers are going to be expected to comply with a law, the statute should include a straight-forward definition that can be understood by plan sponsors without waiting over two years for regulations.

Church/Governmental Plans. What policy justifies an exclusion for church plans but not for governmental plans? Do the churches--which often provided no or few benefits for the rank-and-file--employ many highly compensated employees? Do they deserve separate treatment? Don't most governmental plans provide broad based coverage? Do governmental sponsors cover enough highly compensated employees to justify the additional complexity and governmental expenditures (at all levels) that will be required on compliance? Under current rules, it is simply impossible to determine what the "governmental control group" is. The rule simply cannot be applied until this difficult issue is resolved.

$10/$25 Week Employee Cost. The employee cost approach fails to take into account differences in cost of health care throughout the country and in different businesses of the same employer. An approach limiting employee cost to a percentage of actual cost would be preferable and make much more sense.

Noncorporate Sponsors. The election to forego testing and instead include the employer premium for health coverage on Forms W-2 of highly compensated employees does not take into account noncorporate sponsors.

Definition of Highly Compensated. Having a different definition of highly compensated employee for Section 89 purpose--though administratively helpful--is not good tax simplification policy.

Valuation Issues. Valuation issues have still not been resolved. Until they are, the statute is essentially unadministrable. Valuation remains the most significant Section 89 compliance problem.

Separate Operating Units. The 35 mile rule should be put in Section 414(r)(7), not Section 89.

Disposition and Acquisition Rules. The rules are well intended. In most instances, however, a purchaser will not be in a position to determine compliance "immediately before the change." Determinations and monitoring here are simply impracticable and probably impossible.

W-2 Reporting. Is the special Sections 79(d) and 89 Form W-2 reporting to be separate or combined?

Regulation Requirement. How can the Congress realistically suggest a 6-month regulation requirement? It took over two years to get a partial regulation proposal under Section 89 (promulgated well after the mandated publication date). Plan sponsors deserve adequate lead time following the promulgation of all required regulations before being required to implement change. The policy issues here are not so critical as to justify creating more chaos in this area by changing the rules in a manner that will necessitate substantial plan redesigns without adequate time to implement the changes after the rules become clear.

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COMMENTS OF SUSAN PERRY
VICE PRESIDENT FOR GOVERNMENT RELATIONS
AMERICAN BUS ASSOCIATION

Mr. Chairman, and members of the Committee, my name is Susan Perry and I am the Vice President for Government Relations for the American Bus Association. On behalf of our 700 members operating bus companies in all fifty states, I would like to thank you for this opportunity to comment on section 89.

Our members understand and endorse the concepts behind section 89, those of non-discrimination rules for benefit plans. However, they have encountered serious problems in their implementation , no matter how agreeable the rules may be in theory. We understand that the current section 89 format was chosen in an attempt to provide fair treatment to employers under a broad variety of circumstances, but its myriad of options render it virtually indecipherable.

While I will refrain from repeating the litany of problems that small business has encountered with section 89, the nature of our compliance problems is as follows:

- The number of tests and their application is confusing to our members.

- Employers noted similarities between section 89 requirements and those incorporated in the Department of Labor's ERISA standards, and assumed that they were identical.

- The comprehensive data collection requirements exceeded the amount of time and equipment that our members can practically devote to operating an employee benefits plan.

- The lack of specific guidance and definitions on a number of issues led employers to believe that compliance was only possible with the assistance of special section 89 advisors.

In short, section 89 was acting as a disincentive for employers to provide their employees with benefit plans.

Consequently, Mr. Chairman, we enthusiastically welcome your leadership on this issue. The American Bus Association believes that your proposal, H.R. 1864, contains modifications that will alleviate much of the current problem. Specifically, we endorse:

- The Single Simplified Test: By replacing the multiple test system with a single test, you have created a mechanism that the employers themselves can administer. Without the choices, there is less chance of inadvertent non-compliance.

- Reduced Data Collection: Current Section 89 regulations place an inappropriately heavy information gathering burden upon the employer. H.R. 1864 trims these requirements, effectively cutting the number of administrator hours necessary to document plan compliance.

- One-Day-a-Year-Testing: Current law appears to assume that an employer is guilty of discrimination until they affirmatively prove their innocence. Documenting the thousands of changes that occur within plan administration during the year is unnecessary and creates administrative difficulties. The modification to a one day testing period acknowledges good faith on the part of the employer and reduces the need for sophisticated data processing equipment.

These modifications would considerably simplify Section 89 compliance. In the interest of "fine-tuning" its application to our small businesses, we would like to make the following suggestions:

- Study the impact of Section 89 on Small Business: Many observers have commented on the need for flexible application of non-discrimination rules to small businesses. Given their limited operating budgets, small staffs, and lack of sophisticated equipment, we feel that there may be the need for additional simplification of the rules for small businesses. A small business exemption for firms employing twenty workers or fewer, as recently mentioned, may be the correct route to follow. While no-one has all of the data on this issue now, we would like to encourage and participate in a dialogue on this with the Committee.

- Study the Future Feasibility of Determining Compliance at Higher Levels in the Distribution Chain: All of the current consideration of Section 89 administration centers around data collection and audit at the least centralized, least technically sophisticated level of distribution: the employer. Importantly, the employer is not in business to offer employee benefit plans.

The plan vendor, however, maintains large data banks and computerized systems to administer thousands of plans every day. It would seem much easier to require the vendor to package benefits within a "pre-approved" software format. Employers could then purchase benefit plans assured that, as long as their choices conformed to the plan's parameters, they were automatically in compliance. Any choices made by the employer that resulted in discriminatory excess would generate a computerized "flag" from the vendor's computer. The employer would then be given the choice of declaring the excess and paying the tax or modifying their choice to conform to the rules.

- Raise the Part-Time Employee Coverage Threshold: The definition of part-time employee used in H.R. 1864 for coverage is 25 hours per week. Changing this number from 25 to 30 hours per week would both make it uniform with other Federal standards and more closely mirror our members' feelings as to when employees should receive benefit coverage. Importantly, acceptance of part-time employment, by definition, is an implicit decision to forego the compensation and benefits received from full-time employment in favor of some other benefit. Employers should not be required to compensate part-time employees who work less than 30 hours per week at the same level as full-time employees.

- Adjust Section 89 Rules to Conform with ERISA Where Applicable: As Government oversight in the workplace becomes more comprehensive, employers become confused with conflicting standards. To prevent inadvertent compliance difficulties, every effort should be made to make parallel regulations identical.

- Allow Cafeteria Plans: Under current Section 89 law, employers are allowed to take advantage of a flexible benefits mechanism known as a "cafeteria plan." Many employers use such plans to allow their employees to better satisfy their individual needs by picking those benefits most desirable. We understand many of these plans would not comply with the parameters of H.R. 1864. Where appropriate, provision should be made to allow such plans.

Again, Mr. Chairman, I would like to thank you for your willingness to work with us to generate a proposal that is fair to all. While fairness and simplicity often seem to be competing priorities in tax legislation, we feel that H.R. 1864 satisfies both of these criteria. Please accept our support for your bill and our participation in a continuing dialogue on this issue. Thank you.

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STATEMENT OF THE AMERICAN DENTAL ASSOCIATION ON H.R. 1864 SIMPLIFICATION OF SECTION 89, INTERNAL REVENUE CODE TO THE COMMITTEE ON WAYS AND MEANS UNTIED STATES HOUSE OF REPRESENTATIVES

MAY 12, 1989

The American Dental Association appreciates this opportunity to comment on H.R. 1864, a bill to amend the Internal Revenue Code of 1986 to simplify the antidiscrimination rules applicable to certain employee benefit plans.

Preliminarily, the Association wishes to compliment the sponsors of H.R. 1864 for their recognition of the need to address the burdensome administrative and compliance requirements of Section 89, particularly as these requirements affect small businesses. With the publication of the proposed Internal Revenue Service rules regarding this law, it becomes evident, we believe, that the current Section 89 will not create greater equity in health benefits provided to workers by their employers. Rather, we believe it will create sufficient confusion, frustration and expense to convince many benefit program sponsors, particularly in the small business community, to discontinue benefits and provide alternative compensation to their employees. Such outcome would clearly retard the expansion of health benefit protection in the work force.

H.R. 1864 does much to resolve the complexity and onerous administration of the current Section 89. The qualification requirements of the bill are generally clearly stated. Compliance with them would seem to be within the capabilities of all employers. Certainly, the requirements that the plan be in writing, that employees be provided reasonable notification of benefits available in the plan and that the plan be maintained for the exclusive benefit of employees are sensible and consistent with traditional tax policy which treats health benefits preferentially. The requirement that the employee's rights under the plan be legally enforceable appears appropriate, too. We believe, however, that brief expository language should be added to make clear what action is required of the employer to assure this is the case. The last requirement in this section, i.e., that the plan be established with the intention of being maintained for an indefinite period of time, might discourage the offering of a health benefit by an employer on a trial basis. This approach is not uncommon in small employee-groups when dental benefits are being introduced. For example, a dental plan may be offered for one year, with continuation contingent upon the cost experience of the program.

For this reason, we suggest that this requirement be modified by adding, after "an indefinite period of time," the following: "or, in the case of a new plan, for a specific announced period of time."

The non-discrimination requirements of H.R. 1864 are a significant improvement over the existing eligibility tests. However, we would like to point out two significant provisions of H.R. 1864 that have not taken into account the realities of the insurance market. First, the change in the threshold for part-time workers to be covered under such plans from 17 1/2 hours to 25 hours per week is a marked improvement. However, information received by the Association indicates that in many parts of the country insurance companies refrain from writing health coverage for employees who work less than 30 hours per week. Adjusting the threshold to 30 hours will mesh well with the economic realities already in place.

Secondly, the 90% availability test may prove to be too restrictive. In fact, many small employee-group plans could fail this test through no fault of the employer. For example, a health benefit plan that services an employee-group of ten would presumably fail the 90% test if an insurance underwriter refused to cover two of the employees because of pre-existing conditions, a common practice. With the majority of businesses in this country today operating with less than ten employees, the restrictive nature of the 90% availability test poses a definite problem.

A more workable solution would be to impose the 90% availability test on those employees deemed eligible by the insurance carrier to be covered under "qualified core health plan," which incidentally is not adequately defined. We would recommend that this deficiency also be corrected.

Further, the employee contribution limits for a qualified plan may be too restrictive for small employee-groups. We say this for these reasons: In small businesses, premium sharing of 50% employer, 50% employee, is a common arrangement. Under such an arrangement, with the employee weekly contribution limits in 1989 dollars set at $10.00 (self only) and $25.00 (family coverage), health plans with an annual premium in excess of $1,040 (self only) and $2,600 (family) would not qualify. For employers in some regions of the country, who are unwilling or unable to increase their premium share, these limits may necessitate a trimming of benefits to reduce premiums. Even more common, in our view, would be the situation in which these limits would serve as a disincentive to offering, or continuing, other desirable health benefits, such as dental, if any premium sharing were involved for these other benefits. We recognize that these limits are intended to avoid the circumstance in which a health benefit plan, although technically available to all, is priced beyond the budget of most workers. We believe, however, that, at the least, a provision should be included in the bill to adjust the limits regionally, based on premium costs and assuming 50%-50% premium sharing.

The Association offers the above observations in the hope of improving H.R. 1864 and advancing its purpose of discouraging discrimination against non-highly compensated employees in health plan offerings.

At the same time, we must express our strongest objections to the penalties imposed in the bill for failure of a plan to comply with the requirements in new Sec. 4980C (b) of the Code and for a plan found to be discriminatory. Both these penalties would constitute a tax on health benefits, which the Association maintains is unsound public policy and antithetical to the preservation of the present, pluralistic system of health benefit protection in the nation. We urge that the bill be amended to impose the penalty for offering a discriminatory health plan solely upon the offerer and to define such penalty, and the penalty for failure to comply with the requirements in new Sec. 4980C(b) of the Code, in a dollar amount, so that these penalties may not be construed as a tax.

The American Dental Association also wishes to mention a particular type of health and welfare plan whose status under the bill is somewhat unclear.

The Association endorses a type of self-insured dental benefit plan called "direct reimbursement." A direct reimbursement plan is one in which the employer establishes the amount of benefit to be provided (e.g., $1,500 per person per year) and administers the plan directly by paying the employee's dental bills up to the benefit amount.

The beauty of the plan is its simplicity, low cost and ease of administration. The employer pays no insurance premiums. It can be particularly attractive to small employers because of these features. Employees who fall within an individual plan receive a potential benefit of up to, for example, $1,500 per year in dental benefits. The individual may receive no dental services or only $100 in dental services, or he may receive the full $1,500, depending on dental needs.

Employees who are under a family plan receive a potential benefit of up to, for example, $1,500 per person per year in dental benefits. The family as a whole may receive no dental services or only $100 in dental services, or each may receive the full $1,500, again depending on dental needs.

We have interpreted the bill as allowing these types of plan as long as the same benefit amount is made available to 90% of all non-HCE employees. The Association suggests that language be added to the bill or to the Committee Report to clarify the treatment of such plans.

Additionally, the Association suggests that amendments be made to clarify the status of plans that are self-funded and self-administered (and for which there is no premium structure). The compliance responsibilities of the sponsors of such plans should be detailed. These plans are becoming more common in regard to some types of benefits, dental among them.

The Association appreciates this opportunity to express our observations and concerns relating to H.R. 1864 and hopes that the committee gives them careful scrutiny and consideration.

STATEMENT OF THE ASSOCIATED BUILDERS AND CONTRACTORS, INC.

Associated Builders and Contractors is pleased to comment on H.R. 1864, reforming section 89 of the Internal Revenue Code. ABC represents a diversified group of 20,000 contractors, subcontractors and suppliers united by the Merit Shop philosophy of management -- encouraging a competitive environment in the construction marketplace. ABC's membership is dominated by small businesses -- over 80 percent of ABC's members fall under the Small Business Administration's definition of a small business.

Mr. Chairman, ABC believes that only repeal of section 89 will reverse the current disincentives to health care coverage. However, since the present focus of discussion is on H.R. 1864, we will direct our comments to this bill.

ABC is pleased that you have moved rapidly on this issue, given the onerous compliance burden created for our members and all businesses providing health care coverage to their employees. It is indeed ironic that it is these people who are hurt most by the current law and regulations.

The construction industry already suffers from a severe shortage of skilled labor in many areas of the country. ABC recognizes that to attract skilled craftsmen and women to our industry, we must make health care and other employee benefits more readily available to a more mobile and diverse labor pool. Yet, the net effect of section 89 is to force many contractors to stop supplying any health benefits, and discourage those that were planning to, from ever starting.

ABC agrees with the Committee's goal of an equitable distribution of health care benefits. However, there has been no evidence or study that shows discrimination in benefits is a pervasive problem. As the Small Business Administration has pointed out, the perception that small firms tend to discriminate in the provision of health benefits is not true. Although about three quarters of all the noninsured work for small firms, studies show that small firms with health insurance more frequently offer coverage to all their employees than do large firms. If they cannot, it is usually not because they don't want to, but because of low operating margins, or in the case of construction, the transient nature of the workforce makes it difficult for employers to obtain affordable coverage.

Indeed, it is affordability and access that are the keys to the formation of small business health insurance plans. How contractors offer health benefits is controlled by the necessity of delivering a broad group to the insurance carrier. It is not discrimination, but the failure of tax policy to address employer-provided health care, which prevents total employee coverage.

Again, while repeal is the only effective solution, H.R. 1864 is a significant improvement over current section 89. Substituting a design-based test for several participation-based tests is a considerable simplification. Figuring employee and employer tax status is more predictable, and compliance in general is less complicated and expensive.

Notwithstanding these substantial improvements to current regulations, there are a number of concerns and recommendations ABC would like to make to H.R. 1864. We must emphasize that if these problems are not rectified in the Committee's deliberations, we will have no choice but to continue to support repeal of section 89.

RECOMMENDATIONS

Small Business Exemption

First, embrace the Administration's suggestion that a small business exemption from compliance with section 89 be adopted. Smaller construction firms and small employers in general are disadvantaged by the imposition of complex and costly compliance measures added to escalating health care costs. Confronted with a severely complex legal maze and an unstable insurance market will limit their exposure to such a market by restricting or withdrawing employer-sponsored coverage.

Employee Contribution

ABC is concerned with the maximum employee contribution ($10 per individual per week, $25 per family, indexed to average wage growth). Requiring a greater employer contribution will cause more contractors to cut benefits entirely, or drive them out of business. If such a provision does prevail, we would rather see achievement of affordability through the establishment of minimum employer contributions based on a percentage of wage basis or a cost-based index. A uniform dollar figure ignores regional differences in wages and insurance costs. Moreover, with health insurance costs spiraling contribution figures, reasonable today will be unrealistic within two years.

Such an arbitrary and inflexible employee contribution ceiling will discourage contractors from providing health insurance, especially family coverage. The reason is that mandating a limit on the employee share creates a "cost cliff". Under pre Section 89 law, many contractors phased in health coverage. As profits grew, it expanded coverage and absorbed additional costs.

The contractor-owner is unlikely to make a substantial commitment until confident that the company can handle the costs. He or she may begin by contributing 20 or 50 percent for family coverage, but the opportunity to secure coverage is there. As mentioned above, over time, the contractor's contribution increases. H.R. 1864 prevents such flexibility and makes coverage an "all or nothing" proposition. Fixed dollar limits only delay coverage as the owner is unable to pay the bulk of health insurance costs until the firm's profitability makes it affordable.

Leased Employees

A critical concern relates to the difficulties involved in determining qualification rules for leased employees under H.R. 1864. The bill does provide a leased employee safe harbor rule similar to the rules for qualified pension plans. An employer may disregard a leased employee if the leasing company certifies that the employee has available a core health plan meeting the limitations on employee contributions. This rule applies only if less than 20 percent of the non-highly compensated workforce are leased employees.

ABC and others in the construction industry are concerned that new IRS proposed regulations (26 CFR Part 1, March 7, 1989) would define leased employees so broadly that independent contractors and subcontractors would be treated as leasing organizations. This interpretation goes way beyond Congress' intent when it passed IRC section 414(n) to prevent employee leasing rules from being abused. The regulations would require a subcontractor's employees to be treated as employees of the general contractor for benefit plan purposes. In fact, project owners at the top of the chain would have to pay benefits for the employees of the general contractor as well as the subcontractors.

It's important to emphasize that independent contractors and subcontractors are independent businesses that provide health benefits to their own employees. There may be over 50 of these subcontracting companies on one site during the life of a contract. If subcontractors are declared leasing organizations, then greater than 20 percent of the workforce would be regarded as leased employees and the safe harbor rules would not apply. Under the following very real scenarios, the contractor is placed in a no-win situation.

If for qualification purposes employees of subcontractors are treated as the general contractor's employees, then the subcontractor's employees will have to be notified of the general contractor's health plans. Should the subcontractor's employees not be treated as employees of the general contractor, then including them as subcontractors may cause the plan to fail section 89 because the plans are not for the exclusive benefit of employees.

The general contractor is responsible for all of the compliance requirements, an untenable burden -- especially when considering the multiple subcontractors he or she may have to work with. Consider that if the contractor does not supply notification of the plans to the subcontractors, he may fail the qualification tests if the IRS later deems it necessary. All information for compliance testing must be gathered by the contractor. The same holds true for subcontractors who may have contractual arrangements with second and third tier subcontractors. And, there is no mechanism for ensuring that the actual employer, i.e., the subcontractors in most cases, supply the necessary information to their on-site employees.

Clearly the definition of "leased employee" needs to be simplified and clarified further by Congress for the IRS, especially given the severe tax penalties imposed on employers failing the qualification tests. One possibility is to reexamine the safe harbor rules. If employees are receiving core health coverage, the provider should be irrelevant. For section 89 purposes the leased employee provision should be deleted entirely. Anything less will create a web of complexity that is totally unworkable for contractors and subcontractors.

The leased employee provisions should be held in abeyance for section 89 purposes until these myriad of problems can be corrected.

Implications for Construction and the Davis-Bacon Act

The unique nature of the construction industry employment must be considered when establishing section 89 guidelines. To start, reconciling the Davis Bacon Act requirements with those in H.R. 1864; Davis-Bacon requires that the prevailing wages and fringe benefits be paid to hourly construction laborers on federally and federally-assisted construction projects. The Act applies to union and non-union workers. H.R. 1864 would have the effect of taxing benefits that another federal statute requires employers to pay.

The Department of Labor assesses local conditions to determine what wages and fringe benefits (health insurance) prevail in states, cities and counties. They then issue a general wage determination decision that specifies in dollars and cents the minimum amounts to be paid by contractors and subcontractors to laborers. The Davis-Bacon Act requirements may be satisfied if the employee receives the entire amount -- both wages and fringe benefits -- immediately in cash. If the employers provide health or retirement benefits instead of cash, stringent requirements must be met.

If the employers satisfy Davis Bacon requirements by paying benefits in cash, the method of payment would not satisfy H.R. 1864 as presently written. The employer would have to provide two sets of benefits to satisfy the two statutes. Under Davis-Bacon, there must be the option to pay cash to satisfy the employers obligation to pay cash due to the requirements of the Act.

Suppose the employer applies the Davis-Bacon fringe benefit amounts to pay for health insurance. The employer would provide core health coverage to a large number of hourly workers. Construction workers leave and come back several times a year to the same employer. Imagine the burden of trying to keep track of so many workers' benefit circumstances to determine if you are in compliance with H.R. 1864, even though you're already paying federally-mandated benefits.

Also, since Davis-Bacon amounts may not be used to fund benefits not related to Davis-Bacon work, the employer may be faced with calculating what portion of health benefits should be paid with Davis-Bacon funds. This gets terribly difficult if a craftsman is working for one employer at multiple job sites, some Davis-Bacon, and some not.

The imposition of a prevailing wage is somewhat analogous to the collective-bargaining process. A federal statute takes the place of the negotiated agreements or employer wage rates. Indeed, Davis-Bacon applies to both union and non-union employers. The Labor Department determines the wage and fringe benefit rates for all federal and federally-assisted construction. A federal statute should be given at least the same status as a negotiated contract. Davis-Bacon amounts and workers should be given the same status as collectively-bargained agreements and workers.

Part-Time Employees

Although H.R. 1864 has improved the threshold to 25 hours per week for part-time workers to be considered for purposes of section 89 testing, it needs to be raised to at least 30 hours per week. We have found that in many parts of the country insurance companies will not sell health policies for employees working less than 30 hours per week.

The construction industry is especially sensitive to abuses in this area. Members have gotten stuck in the past with paying for the benefits of family members of employees who put in the minimum required hours, and then soon leave the firm. This provision raises real problems of adverse selection and affordability of the plan to all workers. Insurance companies know that part-time workers are generally greater health risks, and either do not permit them to participate in group health plans or raise rates accordingly. A higher threshold is more in step with economic realties -- any less and contractors are likely to reduce the amount of part time work available.

The 133 Percent Solution?

The taxation of benefits for highly compensated individuals in current section 89 occurs when average benefits exceed 133 percent of rank and file benefits. However, in this bill, the test is much more severe because instead of looking at average benefits of both the highly and non-highly compensated, H.R. 1864 compares what each highly compensated employee receives to the lowest benefit that is taken into account in passing the 90 percent test. This is unnecessarily harsh. Thus comparitive averages is a more realistic test.

This provision is quite clearly a "back-door" tax on employee benefits. If pursuing such a tax policy is the Committee's goal, then ABC would rather see it debated separately on its own merits -

- not as an adjunct to section 89. The issue is far too important to be considered in any other manner.

90 Percent Eligibility

The requirement that 90 percent of all non-highly compensated employees be eligible for coverage is a test for universal coverage, not discrimination. It is especially restrictive for construction insurance purposes because insurance carriers often refuse to cover some individuals because of preexisting conditions or other underwriting practices.

The nature of construction employment also makes this provision very difficult to comply with. Construction jobsites and hence workforces shift constantly. A craftsman may work on one stage of construction, and then move on to another employer as another set of workers with different specialties begins work. That's why the industry's turnover rate is over 300 percent.

Maintaining compliance under such conditions may force a transient workforce and would be next to impossible should the IRS define "leased" employee unfavorably and deem these workers as employees, not as subcontractors' employees. In addition, with a 25 hour per week part-time threshold you are including more workers who may not provide the firm with the extra value sufficient to warrant insurance coverage.

A large portion of our member firms have less than 20 full-time employees. Construction work is completed by a combination of the general, or prime, contractor and a variety of individual subcontractor companies. All are considered employers and have individual workforces. In the realm of these small firms, compliance with the 90 percent test could be especially difficult. For example, if a five person firm is to meet the test, 4.5 workers would have to be covered and the only way such a firm could comply is to cover all five employees.

There should be consistency between statutes. ERISA requires 79 percent coverage, and the minimum coverage rules in IRC section 410 require 70 percent coverage in the pension area. The same policies should apply for section 89.

Qualification Tests and the 34 Percent Excise Penalty

A final concern to ABC is H.R. 1864's imposition of a 34 percent excise tax on benefits if the plans do not meet a five-part qualification test. The test requires that each plan must be in writing; the plan must be established for the exclusive benefit of the employees, spouses and dependents; employees must be given reasonable notification of benefits; and it must be maintained for an indefinite period of time. Although these requirements may seem innocent enough, the proposed section 89 regulations themselves are complicated and difficult to understand.

For example, requiring a "recitation of material terms" in the plan description means that virtually every health plan in the country will have to be rewritten. Requiring the plan to be legally enforceable intrudes on the health plan design. The proposed regulations should be amended to make the rules consistent with COBRA and ERISA requirements, which already contain provisions for legally enforceable and reasonable notice provisions.

There is no logical reason for duplicating existing rules and imposing a severe tax penalty on top of remedies already provided for in ERISA. Certainly a 34 percent excise tax should be reduced. Since a 5 percent penalty is invoked under the Internal Revenue Code for underpayment of taxes due to negligence, a similar policy seems fair for an employer who inadvertently fails to amend a plan or take a new feature into account.

As a last comment, ABC is encouraged by the actions taken so far to rectify section 89. Resolving the issues surrounding this matter will take time. In the meantime, action must be taken to quell the more immediate costs of compliance and frustration our members are now experiencing. We would urge you and your colleagues to work with the Secretary of the Treasury to suspend enforcement of the current law until Congress works its will on section 89.

Mr. Chairman, your bill is a major improvement in the areas of complexity and compliance for contractors providing health care coverage over current section 89. Although H.R. 1864 is a more workable bill, it is still fundamentally a disincentive to employer-provided health insurance and will reverse efforts to expand our Nation's policy goals of expanding coverage.

ABC strongly encourages you to give thorough and thoughtful consideration to the changes we have suggested for H.R. 1864. Without them, compliance with your bill and section 89 is untenable for our members and the particular circumstances of the construction industry. Thank you.

STATEMENT OF

THOMAS F. BRADY, VICE PRESIDENT

BALTIMORE GAS AND ELECTRIC COMPANY

ON H.R. 1864

SUBMITTED FOR THE PUBLIC RECORD

MAY 10, 1989

The Baltimore Gas and Electric Company (BG&E), an investor-owned public utility that serves approximately 2,400,000 residents in the Central Maryland area, commends the House Ways and Means Committee (the Committee) in its efforts to simplify the overwhelmingly complex Section 89 nondiscrimination provisions with the introduction of H.R. 1864. BG&E supports legislation directed toward insuring that benefits are provided to employees on a substantially uniform and affordable basis without regard to levels of compensation.

BG&E administers its welfare plans for the benefit and protection of its employees and their families. The Company has historically enjoyed a reputation in the community as a fair and generous employer. All of BG&E's health benefits are available to virtually all of its 9,000 employees on an identical basis. Lower paid employees have access to the same levels and amounts of coverage at the same cost as higher paid employees. In our opinion, it is inconceivable that such a plan could be deemed to be discriminatory under the tax laws. Preliminary testing under the existing Section 89 rules, done at considerable time and expense, proves that BG&E's health and welfare benefit plans are indeed not discriminatory. It appears, however, that BG&E's plans under the provisions of H.R. 1864 would be 'discriminatory' because the Company provides benefits to its employees through a Section 125 cafeteria plan.

It is unclear whether the bill's potentially harsh treatment of cafeteria plans is inadvertent or intentional. If inadvertent, it can be rectified as discussed below. If intentional, it should be reconsidered. Cafeteria plans provide employers with a vehicle for offering a range of benefit options to employees whose individual benefit needs are diverse. Cafeteria plans also allow employers to address the problem of substantial increases in health care costs during recent years. For example, by giving employees the opportunity to purchase lower option health coverage, employees who choose such an option will have a greater incentive to carefully monitor their medical costs, and will be able to purchase other benefits that meet the employees' needs.

Additionally, in reviewing H.R. 1864, we became aware of other areas of uncertainty regarding the application of specific provisions of the bill. We respectfully urge the Committee to resolve the issues presented in this Statement prior to the enactment of H.R. 1864, so that employers will have a clear and unambiguous statute to work with as soon as the law takes effect. The tax rules are often so complex and confusing that good faith efforts to comply are either unnecessarily costly or totally frustrated. Income tax regulations are generally promulgated well after the effective date of the law. The Committee's efforts to clarify the language in H.R. 1864 would assure more uniform compliance with the statute.

Cafeteria Plans - Employer Credits

Under cafeteria plans, employer-provided 'credits' can generally be used by the employee (1) to purchase core health benefits on a pre-tax basis; (2) to purchase other benefits offered by the plan, on a pre-tax or taxable basis, depending on the benefit; or (3) to receive additional taxable cash compensation. Clarifying language should specify that credits under a cafeteria plan are treated as employer-provided benefits for purposes of meeting the limitations on mandatory employee contributions under the eligibility test. Further, such credits should be treated as employer-provided benefits for purposes of the benefits test for both highly compensated and nonhighly compensated employees. Such changes will insure that cafeteria plans may continue to provide a mechanism for serving diverse employee benefit needs.

Flexible Spending Arrangements

Flexible spending arrangements (FSAs) providing health expense reimbursements are valued cafeteria plan benefit options that serve to mitigate the cost of insurance deductibles, co-payments and medical expenses not otherwise covered by insurance. The statutory language concerning the calculation of taxable benefits under plans meeting the eligibility requirements indicates that FSAs under a cafeteria plan would generally be fully taxable to highly compensated employees. This is the case assuming that employee pre-tax contributions to a health FSA are treated as part of a highly compensated employee's aggregate employer-provided benefit, and that such contributions are disregarded for purposes of the 133-percent portion of the benefits test where salary reduction amounts are treated as employee contributions. Such inequitable treatment distorts the amount of the actual employer-provided benefit. Hopefully, this result was not contemplated, as neither the Floor Statement nor the Description of the Bill mention this significant change.

Core Health Benefits

Clarification is needed with respect to the definition of a 'qualified core health plan' under the bill. Qualified core health plans must be accurately identified so that an employer can properly apply both the eligibility and benefits tests. Proposed regulations recently issued under Section 89 state that core benefits include hospitalization and major medical, but exclude dental, vision, disability, accidental death and dismemberment coverages and FSAs. The Joint Committee's Description of H.R. 1864 indicates an intent to adopt the definition included in the proposed regulations. An affirmative statement of the definition in the statutory language would assure uniform compliance with the nondiscrimination provisions.

The Joint Committee's Description of the bill states that for purposes of the 133-percent portion of the benefits test, an employer may utilize an aggregation rule to increase the level of benefits available to the nonhighly compensated employees if certain requirements are satisfied. An example explains that if a dental plan and core health plan are available to the same employees and the two plans meet the maximum contribution limitation when considered together, then such plans may be treated as one qualified core health plan. Statutory language is required to provide for this permissive aggregation rule.

Eligibility Test

Many benefit plans offer levels of health coverage in addition to individual and family coverage. For example, BG&E offers four levels of coverage: employee only, employee and spouse, employee and child, and family. The limits on employe cost included in the bill's eligibility test should be expanded to provide a $25 per week limitation on all coverage beyond employee only. Further, the health plan taken into account for purposes of the 133-percent portion of the benefits test should reflect the level of coverage chosen by each respective highly compensated employee in computing such employee's taxable benefit.

Benefits Test

Reference to the 'smallest' employer-provided benefit in the statutory language under the 133-percent portion of the benefits test is difficult to interpret, particularly in light of Example 3 included in the benefits test section of the Description of the Bill. The example indicates that the core health plan that meets the eligibility test and includes the 'highest' (rather than the 'smallest') employerprovided benefit should be used for purposes of the 133-percent calculation. This example appears to conflict with the statutory language.

Leased Employees

With respect to leased employees, we urge you to consider several points:

1. A uniform definition of leased employees should be adopted to ease the administrative burden of retaining separate definitions of leased employees for purposes of qualified retirement plans (substantially full time basis for one year) and health plans (six months in lieu of one year).

2. A reasonable transition period for the application of Section 89 to leased employees should be provided to allow an adequate period of time to modify existing contractual arrangements and to allow leasing organizations the necessary time to modify or establish plans that satisfy the qualified core health plan contribution limitations.

3. The 20 percent limitation included in the safe harbor exclusion of leased employees should be deleted. The bill's other exclusion requirement, that the leasing organization provide the qualified core health benefits, should be sufficient to attain the bill's intended health coverage goal for leased employees.

4. Finally, leasing organizations should be required under the tax laws to provide an information return to recipient organizations certifying whether or not a leased employee is eligible to participate in a qualified core health plan maintained by the leasing organization.

BG&E appreciates the opportunity to offer comments with respect to H.R. 1864, and also appreciates the Committee's consideration of our thoughts on the bill. We enthusiastically support the Committee's efforts to simplify the Section 89 provisions while retaining the objective of promoting broad-based employer subsidized and affordable health coverage.

STATEMENT OF THE BLUE CROSS AND BLUE SHIELD ASSOCIATION

The Blue Cross and Blue Shield Association appreciates the opportunity to submit written comments on H.R. 1864, a bill to amend the Internal Revenue Code of 1986 to simplify the nondiscrimination rules applicable to certain employee welfare benefit plans. As the coordinating organization for all the Blue Cross and Blue Shield Plans, we are vitally interested in any federal legislation that affects the administration of employee benefit plans and the scope of benefits that such plans may offer. Our 75 member non profit Plans provide health insurance protection to over 77 million Americans. The majority of this protection is in the form of employment-based group health benefits.

We applaud the Committee's commitment to review the requirements of the Section 89 provision and to consider revisions to the legislation. We are concerned about the increasing demands placed on employers who offer health benefit plans to employees and we are increasingly concerned that additional requirements could result in some employers no longer providing such health benefits.

The Blue Cross and Blue Shield Association has supported fully Congress' initial intent in drafting Section 89--that health benefits provided to highly compensated employees which substantially exceed benefits provided to non-highly compensated employees should not receive favored tax treatment. However, the Section 89 legislation and the proposed regulations implementing the legislation have become so complex that they have become an overwhelming burden on employers. We are concerned that this burden may result in cut-backs or even elimination of employer-provided health benefits especially by small and medium sized employers. We also are concerned about the significant cost to employers of complying with Section 89. For these reasons, the Association strongly supports efforts to simplify Section 89.

Chairman Rostenkowski's bill, H.R. 1864, revises the nondiscrimination legislation, simplifying or eliminating many of the aspects of Section 89 that make its present version costly and administratively complex. By focusing on the availability of coverage rather than how employees sort themselves among options, the bill significantly reduces the amount of data required to comply with Section 89.

Under H.R.1864, the current nondiscrimination tests would be replaced by a simplified eligibility test: at least 90 percent of all nonexcludable, non-highly compensated employees must be eligible to participate in one or more "qualified core health plans"; the plans could not contain a provision related to eligibility that discriminates in favor of highly compensated employees; and required employee contributions to such plans could not exceed $10 per week for single coverage or $25 per week for family coverage. These dollar amounts would be adjusted for post-1988 cost-of-living increases as measured by the Social Security Administration average wage index.

In addition, H.R. 1864 would reduce the number of part-time employees that must be included in testing from those employees working 17 1/2 hours per week to those working 25 hours per week.

H.R. 1864 also would diminish significantly employer data collection burdens, facilitate the performance of the one day snapshot test, lessen the difficulties involved in incorporating leased employees into the employer's workforce for testing purposes, eliminate the need for "sworn statements" and establish more equitable penalties when the plan fails the nondiscrimination qualification tests.

Finally, the bill would clarify that group-term life insurance plans will have to meet the pre-1986 nondiscrimination tests rather than tests designed for health plans.

We support and welcome Mr. Rostenkowski's efforts to simplify the Section 89 requirements as a significant improvement over the current law and regulations. We have identified however, several areas which we believe should be reviewed further. Our specific concerns are outlined below.

The 90 Percent Test

The bill would replace the complicated tests of current law with a single alternative test based on design of the plans. The requirement would be that at least 90 percent of all nonexcludable, non-highly compensated employees be eligible for coverage. While we are fully supportive of making health benefits as broadly available as possible, we believe that the 90 percent standard may be too high and may result in some employers who are currently offering broad based benefits actually failing the tests. We would suggest that the threshold be lowered, perhaps to 80 percent. This would mitigate the adverse impact of the so-called "cliff effect".

Employee Contribution Cap and Index

The Association is concerned about the potential consequences of the dollar limit placed on employee contributions in the definition of a qualified core health plan.

This provision limits an employer's ability to have all employees share in premium costs without imposing a severe tax penalty on highly compensated employees. Consequently, to comply with these provisions, employers have no choice but to lower the cost of their plans by "designing-down" their existing benefit structure, for example, by introducing higher deductibles or copayments. One way to resolve this problem is to increase the employee contribution limits.

The provision indexing future increases in the employee contribution to wages also encourages employers to design-down their plans since medical costs are increasing at a faster rate than wages. Over time, if the cap is indexed to wages, increases in the cost of medical care would significantly reduce the employee's share of the health plan costs. In order to keep in balance the allocation of health care costs between employers and employees, the limits should be indexed to increases in the per-capita U.S. health care expenditures. This indexing mechanism would relieve some of the pressure on employers to design-down their benefits.

Part-Time Employees

H.R. 1864 would increase the threshold for inclusion of part-time employees in the nondiscrimination testing from 17 1/2 hours to 25 hours. We support liberalizing the definition of part-time workers but urge consideration of a phased-in program starting with a definition of part-time workers based on 30 hours (the industry norm today) and moving to 25 hours over the next few years.

Once-a-Year Testing

Although we strongly support the elimination of the continuous testing requirement for non-highly compensated employees, we remain concerned about the continuous testing requirement for highly compensated employees. We would suggest that the bill be revised to provide for a once-a-year test for highly compensated employees.

Salary Reductions

The bill treats salary reduction contributions as employer contributions for determining a highly compensated employee's employer-provided benefit and as employee contributions for purposes of the benefits test and the 90% eligibility test. Such treatment would limit the amount that all employees (non-highly compensated as well as highly compensated) could contribute to a Section 125 plan for core benefits ($520 for employee only coverage and $1300 for family coverage). This treatment would also result in a disparity in coverage provided to highly compensated and non-highly compensated employees. The consequence would be increased potential for taxable income to highly compensated employees obtaining core benefits through salary reduction programs. The bill thus would discourage the use of tax-favored salary reduction programs both for non-highly compensated as well as highly compensated employees. We would be pleased to work with the Committee to resolve this difficult issue.

Leased Employees
Although the bill provides some relief with respect to leased employees, we are concerned that it does not go far enough. The key problem is that companies do not know and sometimes are unable to determine who its leased employees are. In order to provide time for the problems and appropriate solutions to be developed we would urge a one year delay in application of rules related to leased employees or at least delay until the final leased employee regulations are published by the IRS.

Former Employees
The bill proposes a one year delay in Section 89 requirements applicable to former employees. We share Mr. Rostenkowski's concern that most former employees are not in regular contact with their former employers, and that this would exacerbate the data collection problem for employers. We strongly support the one year delay. Further, we would urge, in lieu of the delay, the inclusion of a grandfather provision for these benefits similar to the one included in the current version of Section 89.

Failure to Satisfy Qualification Requirements
The bill adds a new provision to Section 89 that imposes a tax on the amounts paid or incurred under benefit plans which do not meet the qualification requirements currently provided in Section 89(k). However, it is not clear from the proposed statutory language whether the amounts "paid or incurred" are the premiums paid by the employer or the benefits paid to employees under a benefit plan. The Joint Committee on Taxation's Committee Print (JCS 9-89) interprets this provision to mean that the penalty is on premiums paid. We would recommend that the legislative language be clarified to reflect the intent as outlined in the Joint Committee Print.

Maintained for the Exclusive Benefit for Employees
The bill description indicates the exclusive benefit requirement is satisfied even if a de minimis number of nonemployees participate in the plan. However, the bill itself does not suggest this modification. We believe the bill should retain the language of the proposed regulation requiring a service nexus to the employer.

Implications for Small Business
The Association has a special concern regarding the effect of Section 89 requirements on small businesses. We would urge consideration of provisions that would ease the burden on small business sufficiently so that they are encouraged to continue to provide employee benefit programs to their employees and expand these programs to employees that they presently do not cover.

In summary, we support the goal of nondiscrimination in the provision of employee health benefits. However, we are concerned that Section 89, in its current form, may result in the reduction or elimination of employer provided health benefits by many small and medium sized businesses. H.R. 1864 substantially simplifies the administratively burdensome aspects of Section 89, and we commend the Chairman for this major improvement. We believe that the changes we have suggested in our testimony would address many of the business community's remaining concerns with Section 89.

Once again, we appreciate the opportunity to submit written comments on H.R. 1864 and look forward to working with the Committee as these difficult issues are addressed.

STATEMENT OF

CASTLE & COOKE, INC.

SUBMITTED TO

THE COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

H.R. 1864 - Proposed Revisions to Section 89

May 12, 1989

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I.

Introduction and Summary

This statement is submitted by Patton, Boggs & Blow on behalf of Castle & Cooke, Inc. for inclusion in the record of the hearings held by the Committee on Ways and Means on H.R. 1864 and other legislative proposals to revise or repeal the health and other employee benefit plan nondiscrimination standards contained in Section 89 of the Internal Revenue Code. Castle & Cooke, a Hawaii corporation with its principal executive offices in Los Angeles, California, is a major participant in the world-wide food products industry and is a major real estate owner and developer. Castle & Cooke is generally supportive of the basic thrust of H.R. 1864; namely, to restructure and greatly simplify the inordinately complex provisions of current Section 89 without abandoning the important policy objectives that prompted Congress to enact that provision as part of the Tax Reform Act of 1986.

This statement is directed to the so-called "separate line of business" exception contained in current Section 89(g)(5). Under this exception, which would be retained without substantive change by H.R. 1864, if an employer has separate lines of business or separate operating units, the nondiscrimination rules of Section 89 (and the qualified retirement plan minimum coverage requirements of Section 410(b)) are applied separately to each separate line of business or operating unit. The separate lines of business exception thus recognizes and encourages competitiveness among providers of different products and services without abandoning fundamental nondiscrimination policy objectives.

Castle & Cooke believes that a single common definition of "separate line of business" is essential and, as explained below, that the present test set forth in Section 414(r) requires additional precision. H.R. 1864 should be amended to assure such identity of definition and to clarify the manner in which the "separate line of business" test (now set forth in Section 414(r) and applicable by cross references to Section 410(b) and, with certain modifications, to Section 89) is to be applied to diversified companies such as Castle & Cooke.

Castle & Cooke fully expects that, under Section 414(r), its real estate development activities would be considered a line of business separate from its participation in the food industry. Moreover, Castle & Cooke believes that its world-wide participation in the food industry should not be treated as one single line of business under the existing provisions of Section 414(r). Such treatment would not be in accordance with the purpose of the separate line of business exception, because the food industry consists of many competitive environments that are fundamentally different from each other and Section 414(r) should be clarified in this respect.

As explained more fully below, the activities of Castle & Cooke (and its directly and indirectly owned subsidiaries) in the world-wide food products business are organized into separate business groups. The different competitive environments within which each business group competes impose a market-oriented discipline on the "benefits" component of their respective cost structures (i.e., benefit levels must be sufficient to attract and retain qualified employees, but cannot be so costly that they impair the ability to compete effectively). Section 414(r) was enacted to address precisely this kind of situation, but legislative clarification is vitally needed.

II.

Castle & Cooke Food Products Activities

A. Overview.

Originally, the activities of Castle & Cooke in the food industry were limited to packaged foods (mostly canned pineapple) and sugar. Today, largely as a result of acquisitions made over the past three decades, Castle & Cooke's world-wide food products activities employ approximately 42,000 people (about 10,000 of whom work in the United States) involving the following:

- bananas and fresh pineapples
- packaged foods
- table grapes
- citrus fruits
- fresh vegetables
- dried fruits and nuts
- sugar
- retail food operations

With the exception of the packaged foods business group (operated as a separately managed unincorporated division of Castle & Cooke), each of the business groups is operated through one or more separate subsidiaries of Castle & Cooke.

Most of the food business groups use the "Dole" name on one or more of their products and are subject to oversight from the parent company, but these similarities should not obscure their fundamental differences and operational independence. Each of the business groups has a separate organizational structure and is headed by a separate management team that is accountable for that business group and with separate production and/or marketing personnel. Each business group is headquartered in a different geographic location and operates as its own profit center with exclusive responsibility for operations, pricing, cost control and all other aspects of its business activities. In short, each business group could stand alone as an independent company. Moreover, with the exception of certain 1987 acquisitions, the business units operated in this autonomous configuration prior to the enactment of Sections 414(r) and 89.

B. Illustration of the Problem.

The situation confronted by Castle & Cooke and other similarly situated employers may readily be illustrated through a brief summary description of three of the several business groups into which Castle & Cooke has organized its world-wide food business: (1) bananas and fresh pineapples; (2) packaged foods and (3) table grapes.

1. Bananas and Fresh Pineapples. Through this business group, headquartered in Boca Raton, Florida, Castle & Cooke exports fresh bananas grown in foreign countries (Costa Rica, Honduras, Columbia, Ecuador and the Philippines) by indirect subsidiaries of Castle & Cooke and by unrelated third parties. The domestic employees of this business group manage the operations of the foreign subsidiaries and arrange for the purchase, distribution and sale of bananas. Such sales are made in North America, Western Europe, the Far East and the Middle East. (Certain domestic employees of this business group also are responsible for the distribution and sale of fresh pineapple grown in Hawaii, Honduras, and the Philippines by a division of Castle & Cooke.) The principal competitors for this portion of this business group are United Brands, Del Monte and other importers.

2. Packaged Foods. Dole Packaged Foods, a division of Castle & Cooke headquartered in San Francisco, California, produces and markets processed foods, such as packaged pineapple products (sliced, chunk, and crushed pineapple in cans), juices, frozen desserts and other packaged food products. These products are sold in various markets, principally in North America, Europe and Japan. The various products of Dole Packaged Foods compete against products of companies in their own markets, including Del Monte, Maui Pineapple, and various importers of the Thai pineapple for pineapple products, Del Monte and Minute Maid for juices, and General Foods, Pillsbury, Kraft, United Brands and other manufacturers and dairies for frozen desserts.

3. Table Grapes. The employees of a separate business group, headquartered in Bakersfield, California and acquired by Castle & Cooke in 1987, grow California table grapes and provide packing and marketing services. The principal competitors of Castle & Cooke in the area of table grapes are independent family-owned businesses.

In order to compete effectively on a world-wide basis, each of these business groups and the other Castle & Cooke business groups must have a cost structure that reflects the realities of its individual environment. This means that, with respect to employee benefits, each business group must provide benefits that are sufficient to attract and retain qualified employees, but which do not increase costs to the point where they impair the ability of that business group to compete effectively.

III.

The Need for Legislative Clarification

Neither section 414(r) nor the legislative history of that provision provides adequate guidance with respect to what constitutes a "separate line of business" and whether any such separate line of business was established for "bona fide business reasons." Statutory clarification is required on both of these points to insure that companies such as Castle & Cooke which operate in multiple environments have adequate assurance that their separate business operations will be treated as such under section 414(r).

As the preceding food business group illustrations indicate, the Castle & Cooke organization structure exists for bona fide business reasons and is not designed to thwart any nondiscrimination employee benefit rules. Consequently, the Castle & Cooke food organizations ought to be treated as "separate lines of business" under Section 414(r).

The cost structure point in the preceding illustrations is critical. To take but one example, if Castle & Cooke were required to equalize the benefit levels of the domestic employees of the bananas and fresh pineapples business group with those of the table grapes business group, it would face an impossible choice. It could raise benefit levels in the table grapes business group to those prevailing in the bananas and fresh pineapples business group (thus pricing itself out of the competition in the table grapes business group). Alternatively, it could lower the benefit levels of the domestic employees in the bananas and fresh pineapples business group to those prevailing in the table grapes business group (thus jeopardizing its ability to attract and retain qualified domestic employees in the bananas and fresh pineapples business group).

Castle & Cooke, and other similarly situated employers, should not face such a choice. If these two business groups (bananas/fresh pineapples and table grapes) were owned and operated by different corporations, they could both provide benefit levels consistent with the respective cost structures to which they must conform. There is no reason to require a contrary result just because both business groups are owned by a single corporation such as Castle & Cooke and Section 414(r) can and should be applied to prevent such a result. Treatment of the business groups of Castle & Cooke engaged in the world-wide food industry as "separate lines of business" under Section 414(r) would accord both with Castle & Cooke's actual operations and with the differing cost structures and other business realities each such business group must confront while still accomplishing the important policy objectives that prompted Congress to enact that provision as part of the Tax Reform Act of 1986.

IV.

Conclusion

It obviously is essential that legislation such as H.R. 1864 be enacted to resolve the myriad of problems presented by current Section 89. For the reasons set forth in this statement, Castle & Cooke believes H.R. 1864 should be amended to clarify explicitly that the "separate line of business" test (as applicable for all relevant purposes) was intended to avoid the very kind of problems now confronted by Castle & Cooke as it seeks to provide benefit levels consistent with the cost structure and employee retention constraints faced by each of its business groups. Castle & Cooke stands ready to assist the Committee on Ways and Means and its staff in developing appropriate and workable "safe harbor" or other provisions to deal with such issues in a responsible fashion and to provide such additional information as may be appropriate with respect to its own business groups in the world-wide food industry.

PATTON, BOGGS & BLOW

STATEMENT OF
CONSOLIDATED FREIGHTWAYS, INC.

REGARDING
SECTION 89 OF THE CODE

SUBMITTED TO
THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

MAY 19, 1989

I. INTRODUCTION.

Consolidated Freightways, Inc. appreciates the opportunity to express support for Chairman Rostenkowski and other members of the House of Representatives for their efforts in attempting to simplify Section 89 through the introduction of H.R. 1864. Consolidated Freightways agrees with and recognizes the need for these efforts, and believes that H.R. 1864 is a significant and timely step in the right direction.

Consolidated Freightways is a worldwide trucking, air cargo, and ocean service freight transportation company, with approximately 47,000 employees. Recently, Consolidated Freightways expanded its air cargo services through its April 1, 1989 acquisition of Emery Air Freight Corporation, thereby adding approximately 13,500 employees. Our employees are covered by numerous employee benefit programs. Prior to the Emery acquisition, Consolidated Freightways sponsored three single employer health care plans and approximately 184 collectively bargained, multiemployer health care plans. On a combined basis, the Consolidated Freightways and Emery group of corporations sponsor approximately 30 single employer health care plans and over 200 multiemployer health care plans.

Compliance with current Section 89 has been a costly endeavor for Consolidated Freightways, requiring extensive and detailed data development and analysis. Our preliminary testing indicates that most, if not all, of the original 187 Consolidated Freightways health care plans can be expected to satisfy the testing requirements of current Section 89. Similarly, our preliminary analysis indicates these health care plans can also be expected to pass the proposed eligibility test contained in H.R. 1864. Since we have just recently begun to collect data relating to Emery's health care plans, we do not yet have firm information regarding these plans. However, our preliminary review indicates that these plans can be expected to satisfy both current Section 89 and H.R. 1864's eligibility test.

Thus, we believe Consolidated Freightways is in a relatively unique position to comment on H.R. 1864. Consolidated Freightways agrees generally with the policy and purpose of current Section 89. We recognize that the federal income tax subsidy for employer-provided health care is justifiable only for plans that do not discriminate in favor of highly compensated employees, especially during this period of continuing budget deficits. Additionally, we support implementation of these policies through procedures that are administratively reasonable and fair.

First, we urge Congress to provide relief for all employers without regard to size. Next, we express our concerns regarding the so-called "cliff effect" that results if a plan fails the 90 percent eligibility test. We also discuss a number of problems that are particular to collectively bargained plans under both current law and H.R. 1864. In addition, we suggest a modification to the effective date of the bill to allow employers to elect to apply H.R. 1864 separately to health care plans that cover employees of newly acquired companies. Finally, we suggest several modifications to the special rule for acquisitions and dispositions.

Consolidated Freightways sincerely hopes that these comments will prove helpful to the Committee members and their staffs as Congress reviews legislative modifications to Section 89. Additionally, we look forward to discussing these comments with you and providing further assistance.

II. DISCUSSION.

A. Relief Under Section 89 Should Apply Generally.

There appears to be little question that under current Section 89, most employers must expend significant time and resources in order to determine whether their health plans provide discriminatory benefits that must be included in income. We empathize with the concerns of many small employers who are troubled by the level of complexity and the cost of compliance with current law. However, Consolidated Freightways' concerns arise from its own frustrations in dealing with Section 89. As noted above, Consolidated Freightways now maintains over 200 single and multiemployer health benefit plans that cover over 47,000 employees. The level and extent of data collection and calculations that we must perform under current law are extensive, overwhelming and expensive, as they are for most if not all employers who provide health benefits to a work force as large and diverse as ours.

Thus, Consolidated Freightways would urge Congress to simplify Section 89 in a manner that helps all employers. Consolidated Freightways appreciates and understands Congress's special concerns regarding many interest groups. However, we would submit that any special rule that merely helps a limited group of employers, while leaving other employers to struggle with the problems of current law, would be extremely inappropriate and unfair.

B. H.R. 1864 -- The "Cliff Effect."

As noted earlier, preliminary testing by Consolidated Freightways suggests that most of the Consolidated Freightways health plans would satisfy the eligibility test of H.R. 1864. We are still uncertain whether testing the Consolidated Freightways plans on a combined basis with the Emery plans will produce similar results, although we believe these plans would still satisfy the eligibility test.

However, Consolidated Freightways does not have an enormous margin for error in this regard. For example, our initial review indicates that between 92 and 93 percent of our non-highly compensated non-union employees are eligible to participate in an affordable health plan. Any number of events could change this result for either our union or non-union plans. Unanticipated changes, which could be driven by factors entirely out of Consolidated Freightways' control, could result in our failing the eligibility test.

We are particularly troubled by what appears to be a severe cliff effect for failing the eligibility test. Notwithstanding the fact that 89.9 percent of our employees might be eligible to participate in a particular health plan, Consolidated Freightways would be required to impute as income the full value of employer-provided benefits received by all highly compensated employees covered by that plan. The result would be an employee relations disaster. Most importantly, we believe this result is unfair to those employees where the failure is unanticipated.

One way to address this problem might be to adjust the sanction for failing the eligibility test to reflect the extent of the shortfall. For example, a sliding scale could be used, under which the percentage of employer-provided benefits included in the employee's income would gradually be increased to 100, based on the difference between 90 percent and the plan's actual eligibility percentage. In addition, an option could be provided to permit an employer to elect to pay a tax in lieu of the tax on its highly compensated employees for de minimis failures of the 90 percent test. We would urge the Committee to modify the tax imposed for failure of the eligibility test under H.R. 1864 to eliminate this "cliff effect."

C. Special Problems Affecting Collectively Bargained Plans.

For Consolidated Freightways, the most dramatic simplification achieved by H.R. 1864 is produced by eliminating the necessity for comparing the employer-provided benefit under one health plan with the employer-provided benefit under another health plan. Consolidated Freightways supports the concept of testing the percentage of employees who are eligible to participate in health plans, as opposed to testing the relative values of benefits provided to employees. Although significant data collection would still be required under H.R. 1864, the difficulty associated with testing all multiemployer and single employer plans together under current law would be greatly reduced.

However, several problems which arise under current law, as well as under H.R. 1864, with regard to the application of Section 89 to collectively bargained plans should be brought to the attention of the Committee. Accordingly, the following discussion focuses on testing collectively bargained single employer and multiemployer plans under current law Section 89 and under H.R. 1864.

1. Unit-by-Unit Application of Section 89.

H.R. 1864 would modify current law to require employers to apply Section 89 separately with respect to each qualified collective bargaining unit. Consolidated Freightways strongly supports this modification. Unit-by-unit application of Section 89 would not reduce the amount of data that Consolidated Freightways would need to collect with regard to its union employees. However, applying Section 89 separately to each bargaining unit would eliminate the possibility that failure of the discrimination test by one collectively bargained unit would result in imputed income to highly compensated employees covered by another collective bargaining unit or by a non-union plan. This result strikes us as a significantly more fair result than that achieved under current law.

However, Consolidated Freightways has some concerns regarding how H.R. 1864 would apply to collective bargaining agreements that are in effect when the new legislation becomes effective. Most of Consolidated Freightways' collectively bargained agreements are three year agreements, and could not be reopened during that time period. The Committee should provide a delayed effective date for collectively bargained plans at least until ratification of the next collective bargaining agreement. A similar approach was taken in the Tax Reform Act of 1986. In that act, Section 1151(k)(2) delayed implementation of Section 89 for collectively bargained plans until the earlier of 1991 or ratification of the next collective bargaining agreement. Similar relief should be provided under H.R. 1864.

2. Separate Testing of Former Employees.

Both current law and H.R. 1864 would require Consolidated Freightways to test former employees separately from active employees. Significantly, H.R. 1864 would delay separate testing of former employees until 1990.

Consolidated Freightways supports delaying the effective date for separate testing of former employees, particularly for multiemployer plans. Since the trustees of each multiemployer plan typically determine whether former employees will receive health benefits, as well as the level of benefits provided, the trustees ultimately determine whether health benefits will be paid to former employees in a nondiscriminatory manner. Although employers elect one half of these trustees, each employer has limited influence over the actual decisions made.

More importantly, Consolidated Freightways has no access to the pertinent trust information regarding the level of benefits paid either to former or to active employees. Since retirees receive their benefits directly from the multiemployer trust, Consolidated Freightways does not maintain records for retirees. Instead, all of the required information for former (and current) employees is held by the multiemployer trust. Consolidated Freightways has requested information regarding its active employees from the multiemployer trusts to which it contributes; however, a complete response has not yet been received. Since there is no penalty on the trustees for failure to cooperate on a timely basis, employers who sponsor multiemployer plans are in an extremely difficult position.

Finally, even if Consolidated Freightways were able to obtain this information, we are concerned as to how these rules would apply to former employees, particularly with regard to the category of former employees who would be subject to testing. For example, since a retiree may be eligible for health benefits as a result of his employment with a different plan sponsor, or several plan sponsors including Consolidated Freightways, some determination must be made as to which plan sponsor should include such employee within the sponsor's group of former employees for testing purposes.

Thus, Consolidated Freightways commends the sponsors of H.R. 1864 for their willingness to delay the effective date of this provision, and urges Congress to study the treatment of former employees under Section 89 during the one year delay to determine the appropriate treatment of such employees. We would be pleased to work with the Committee to develop such rules.

3. Valuation of Employer-Provided Benefits.

Under current law and under H.R. 1864, an employer must determine the value of health care benefits provided to its employees. Until Treasury publishes tables to establish these values, employers generally may use the health care continuation rules enacted by Congress in the Consolidated Omnibus Budget Reconciliation Act of 1985, or COBRA costs, to establish the value of such benefits.

An employer may treat the contribution it makes to a multiemployer plan on behalf of an employee as the employer-provided benefit of such employee under the plan. This election greatly simplifies the task of determining employer-provided benefits under a multiemployer plan. Consolidated Freightways supports retention of this special multiemployer election in H.R. 1864. However, in spite of the simplification provided by the special multiemployer plan valuation rule, Consolidated Freightways would urge

Congress to consider the following issues regarding valuation of employer-provided benefits generally under Section 89.

a. Group Term Life and Disability Income Benefits.

Under current law, disability income benefits are not subject to nondiscrimination testing under Section 89, and group term life insurance benefits must be tested separately. In contrast, H.R. 1864 provides that group term life insurance is not subject to testing under Section 89 but instead would be tested under pre-1986 Section 79 nondiscrimination rules. Consolidated Freightways supports the decision to return testing of group term life insurance benefits to pre-1986 law.

Most if not all of the multiemployer plans to which Consolidated Freightways contributes provide group term life insurance benefits and/or disability income benefits. Thus, in computing the portion of each multiemployer plan contribution that is attributable to the provision of health benefits subject to Section 89, we must subtract the portion of each such contribution that is attributable to group term life and disability income benefits from the total contribution made on behalf of each employee. The remainder, i.e., the portion attributable to the provision of health benefits, is then used for testing under Section 89. This calculation would be required under H.R. 1864 as well.

As with other multiemployer plan information, Consolidated Freightways does not have access to the trust data relating to the cost of providing these benefits. As noted above, Consolidated Freightways has requested this information from a number of large multiemployer trusts, but has not yet received a complete response. To address this problem, Consolidated Freightways would propose creation of a safe harbor, which would permit an employer to assume that some small percentage of multiemployer trust expenses are attributable to the provision of group term life and disability income benefits. Although Consolidated Freightways does not have a great deal of information, we believe that multiemployer trust expenses for the provision of group term life and disability income benefits are typically between five and ten percent of total trust costs for most of its multiemployer trusts. Congress could allow Treasury to determine the appropriate percentage for the proposed safe harbor.

Alternatively, Congress could permit employers who contribute to a large number of multiemployer plans to use an average of the costs incurred by those multiemployer trusts which have responded to requests for data, to approximate the cost of providing such benefits by trusts that have not responded to requests for data. Since the value of these benefits is much smaller than the value of health benefits, use of an average amount should provide a rough estimate of actual trust costs.

Finally, we would like to note what appears to be a drafting error in H.R. 1864. H.R 1864 would restore pre-1986 nondiscrimination testing to group term life insurance. Section 1(c)(2) of the bill would delete the list of employees who may be disregarded under current Section 79(d)(3)(B), which includes employees covered by a collective bargaining agreement, and instead provide that employees who are listed in Section 89(d), as amended by the bill, could be disregarded. New Section 89(d) does not include employees covered by a collective bargaining agreement. We assume that the authors of the bill did not intend to modify pre-1986 law with regard to employees who are covered by a collective bargaining agreement. Accordingly, Section 1(c)(2) of the bill should be amended to correct this oversight.

b. Comparison of Single and Multiemployer Plans.

Under the general rules of Section 89, the employer-provided benefit provided under a single employer health plan is essentially the COBRA cost valuation for each employee for testing years beginning before 1991. As noted previously, an employer may elect to treat its contribution to a multiemployer trust as the employer-provided benefit to employees covered by the trust.

However, if an employer attempts to aggregate single employer plans with multiemployer plans for purposes of helping these plans satisfy the Section 89 requirements, the value of benefits provided under these different plans must be adjusted to take into account differences between the two methods. For example, while the COBRA cost computation for Consolidated Freightways' single employer plans takes into account differences in dependency elections made by its employees, Consolidated Freightways' contributions to its multiemployer trusts are the same for each employee regardless of the employee's dependency status.

If such an adjustment were not made, the comparative values used in testing under Section 89 would be distorted. This kind of adjustment does not appear to be contemplated under the current statute, yet would seem to be required by the consistency rule contained in the proposed regulations.

H.R. 1864 avoids the difficult problem of determining comparability between the same kind of plans and between single and multiemployer plans, since no such comparison of values is required. In addition, H.R. 1864 would require Section 89 to be applied separately to each collective bargaining unit, thereby resolving most of these difficult issues completely. Consolidated Freightways strongly supports the approach taken in H.R. 1864.

However, if Consolidated Freightways were required to impute income to its highly compensated employees, both current law and H.R. 1864 would require Consolidated Freightways to determine COBRA costs for employees covered by its single employer and multiemployer plans. As noted above, Consolidated Freightways does not have access to COBRA costs and other pertinent information for employees covered by multiemployer plans. Instead, Congress should simplify the computation of imputed income under a multiemployer plan by using the multiemployer plan contribution as the employer-provided benefit rather than COBRA costs. This would greatly simplify the imputed income computation for multiemployer plan sponsors, and conforms to the use of the plan contribution as the employer-provided benefit for testing multiemployer plans.

c. Treatment of Part-Time Employees.

Many of the Consolidated Freightways multiemployer plans require Consolidated Freightways to contribute a specific hourly contribution rate for each hour worked by an employee. For example, Consolidated Freightways may contribute $2 for each hour worked by an employee covered by a particular collective bargaining agreement. When combined with the rule that allows an employer to treat its contribution to a multiemployer plan as the employer-provided benefit for each employee, the deemed benefit provided to a part-time employee under a multiemployer plan is exactly proportional to the hours worked by the employee.

Section 89(j)(5) of current law provides that a health plan shall not fail Section 89 merely because the employer-provided benefit is proportionately reduced for employees who work less than 30 hours per week. This suggests that an employer may proportionately increase the employer-provided benefit for such employees for testing purposes. In contrast, the General Explanation of the Tax Reform Act of 1986 (the "Blue Book") permits an employer to double the value of benefits deemed provided to employees who work less than 22.5 hours per week, and to increase by 1/3 the value of benefits deemed provided to employees who work between 22.5 and 30 hours per week. The Blue Book sanctions this adjustment for the 90 percent/50 percent eligibility and 75 percent average benefit tests, but does not mention the alternative 80 percent coverage test.

H.R. 1864 clarifies the treatment of employees who work less than 30 hours per week. Under H.R. 1864, the employer-provided benefit may be proportionately increased for employees who normally work less than 30 hours per week. Consolidated Freightways supports this provision.

However, the bill does not permit a similar proportionate adjustment for all employees. If the purpose of the 30 hour rule is to allow an employer to provide a reduced level of benefits to part-time employees as long as the benefits provided are in proportion to the number of hours worked, then it seems reasonable to extend this rule to employees who work more than 30 hours but less than full time as long as the benefit provided is in direct proportion to the number of hours worked. In addition, employees who work more than full time should not be treated as having received a greater employer-provided benefit merely because the employer's contribution to the multiemployer plan includes overtime hours worked. Proportional adjustments of employer-provided benefits to a full time equivalent rate seem particularly appropriate where the employer elects to treat the employer's contribution to the multiemployer plan as the employer-provided benefit.

Of course, use of a full time contribution rate for all part-time and overtime employees could reduce the amount of taxable benefits under the bill, by increasing the smallest employer-provided benefit under a plan and by reducing the employer-provided benefit for highly compensated employees who work more than full time. However, as long as the deemed benefit provided is in direct proportion to the number of hours worked, this result should not be considered a discriminatory provision of benefits. We would urge the Committee to permit sponsors of multiemployer plans to treat the deemed employer-provided benefit as the full time equivalent amount where the employer contribution is based on the number of hours worked and the special multiemployer valuation rule is used.

4. Application of Section 4976 to Multiemployer Plans.

Under Section 4976(c), an excise tax is imposed on an employer if a discriminatory health plan is part of a welfare benefit fund. The tax imposed equals 34 percent of the lesser of the aggregate excess benefits for that year or the taxable income of the fund for that year. Since a welfare benefit fund is defined as including Section 501(c)(9) trusts, the sponsor of a collectively bargained, multiemployer plan could be subject to this tax.

If the purpose of Section 4976(c) was to prevent employers from avoiding Section 89 by establishing a voluntary employee benefit association, then it seems unnecessary to apply this tax to collectively bargained, multiemployer plans since the circumstances under which such plans are established, namely an arm's length collective bargaining process, essentially preclude a tax avoidance motive.

In addition, imposition of this tax on multiemployer plan sponsors seems unfair. The employer contribution to a multiemployer plan on behalf of each employee, and other conditions, are negotiated as part of the collective bargaining process between the employer and union representatives. In some situations, the employer contribution and conditions are negotiated by a group of industry representatives who represent many employers.

Congress has determined that highly compensated employees should include in gross income the value of excess benefits provided under a discriminatory health plan. However, it seems particularly unfair to impose an additional excise tax on the employer where the provision of such benefits is not solely within a single employer's control. Accordingly, we would urge the Committee to exempt collectively bargained, multiemployer plans from Section 4976(c) completely. However, if the Committee is concerned that some collectively bargained, multiemployer plans can be used to circumvent Section 89, then the Committee should consider applying Section 4976(c) only to such plans that are established to avoid Section 89.

D. Effective Date of H.R. 1864.

The amendments proposed in H.R. 1864 would generally apply to years beginning after December 31, 1989. However, under a special rule an employer may elect to apply H.R. 1864 to its 1989 year. As indicated above, Consolidated Freightways has already conducted extensive testing efforts under current law. Employers who have already begun testing under current law should not be penalized by a change in the law. Consolidated Freightways supports this provision.

However, H.R. 1864 would require an employer to make this election with regard to all plans of such employer. Unfortunately, although Consolidated Freightways has conducted preliminary testing under current law, Emery had not begun its data collection efforts prior to the acquisition on April 1, 1989. The bill would not permit Consolidated Freightways to test the Consolidated Freightways plans under current law and test the newly acquired Emery plans under the simplified method contained in H.R 1864. And yet, the very elements which make this election fair in the first place -- substantial reliance by conscientious employers and significant uncertainty with regard to the state of the law -- exist with respect to both the Consolidated Freightways and the Emery groups of health plans.

Essentially, the limited scope of the election would operate as a penalty for Consolidated Freightways. Consolidated Freightways could only benefit from substantial testing of its original plans under current Section 89 if it chose to test the Emery plans under the more difficult and costly rules of current Section 89. Alternatively, Consolidated Freightways could test the Emery plans under the simplified testing method contained in H.R. 1864, but only if Consolidated Freightways incurs the additional cost of retesting its own plans under the new legislation. Either choice results in additional compliance costs for Consolidated Freightways for 1989 when compared to costs incurred by other employers in 1989.

We are not suggesting that this election be made available on a plan-by-plan basis. Rather, we believe the transition rule should be modified to take into account the special circumstances encountered by employers who acquire other companies during 1989, without providing the potential for adverse selection. Accordingly, we propose that the election contained in Section 1(f)(2) of H.R. 1864, relating to effective dates, be amended to read as follows:

> "(2) ELECTION TO HAVE AMENDMENTS APPLY IN 1989.--An employer may elect to have the amendments made by this section apply to years beginning after December 31, 1988. Such election shall apply to all plans of the employer, and once made shall be irrevocable. However, if a person becomes a member of a group described in section 414(b), (c), (m) or (o) during the employer's year beginning after December 31, 1988 and before years beginning after December 31, 1989, an employer may make this election separately with regard to such person."

This modification would prevent penalizing employers who made acquisitions in 1989, but had already taken substantial steps towards complying with Section 89.

E. Transition Rule for Acquisitions and Dispositions.

Section 89(j)(8) of current law provides a special transition rule for certain acquisitions and dispositions. Under this rule, the requirements of Section 89 are generally treated as having been met during a transition period with respect to any plan covering employees of either an acquiring or target company, if (1) the requirements of Section 89 were met with regard to such plan immediately prior to the acquisition; and (2) the coverage under the plan is not significantly changed during the transition period (other than by reason of the change in membership of such group). For purposes of this special rule, the "transition period" begins on the date the acquisition (or disposition) occurs, and ends on the last day of the first plan year beginning after the date of the transaction. This transition rule would permit an acquiring company to avoid testing either the acquired or the existing company's plans during the transition period. Instead, both the existing plans and the new plans are treated as meeting Section 89 during the transition period. H.R. 1864 retains this transition rule, with an important modification discussed more fully below.

We are concerned that this transition rule does not provide the kind of relief Congress may have intended, both under current law and as contained in H.R. 1864. First, the scope of relief provided under the transition rule is not clear under current law. The statute provides that an employer is treated as meeting the requirements of Section 89 only if the requirements of Section 89 are met by both employers' plans immediately before the acquisition. This seems to suggest that the transition rule would be available as long as both the acquiring and target companies include the appropriate amount of excess benefits in income of their highly compensated employees prior to the transaction. In contrast, the conference report and Blue Book seem to extend the transition relief only if both employers' plans satisfy the coverage requirements of Section 89 prior to the acquisition.

H.R. 1864 resolves this ambiguity. Under the bill, the plans of the acquiring and target companies must satisfy the eligibility test of proposed Section 89(c) immediately prior to the acquisition. Since an acquiring company has no control over the eligibility requirements of the target company's health plans prior to the acquisition, the availability of the transition rule will depend entirely on the plan design of the target company. Thus, H.R. 1864 would substantially restrict the availability of the transition rule.

H.R. 1864 also would restrict the transition relief provided. The bill would only treat the eligibility test of

Section 89 as met during the transition period. Although generally an employer could include the full value of employer-provided benefits in income of its highly compensated employees in lieu of actual testing, the transition rule would not allow an employer to include the appropriate amount of taxable benefits on its employees' W-2 Forms during the transition period in order to avoid additional testing.

Finally, both current law and H.R. 1864 would require that the coverage under either plan not change significantly during the transition period. Since Consolidated Freightways is considering terminating the Emery health plans and offering health care coverage to the former Emery employees under the more generous Consolidated Freightways Health Plan, this increase in employer-provided benefits would render the transition relief inapplicable to Consolidated Freightways. Literally read, the provision would discourage an employer from increasing health benefits provided to its new employees after an acquisition.

In lieu of the existing transition rule, Consolidated Freightways would urge Congress to provide a more generally applicable transition rule for acquisitions and dispositions. Congress should provide a transition period of at least one year after an acquisition during which an acquiring company could elect to test its own health plans separately from the health plans of the acquired company. As long as both the acquiring and the acquired companies include the appropriate amount of taxable benefits in income of their respective highly compensated employees, the policies and objectives of Section 89 would be satisfied.

A more general transition period is justifiable for a number of valid business reasons. First, this transition period is necessary to provide the acquiring company some time to verify the data of the acquired company. Further, allowing separate testing during the transition period would prevent discriminatory benefits provided by one company from causing imputed income to highly compensated employees of the other company. Finally, if the newly acquired company does have discriminatory health plans, the acquiring company would need some period of time before such plans could be amended to eliminate the discrimination.

III. CONCLUSION.

We hope these comments prove useful as the Committee begins its consideration of H.R. 1864. We would be pleased to respond to any questions, or to provide further information if required. In that regard, please do not hesitate to contact:

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HOUSE COMMITTEE ON WAYS AND MEANS

STATEMENT FOR THE RECORD

BY SENATOR PETE V. DOMENICI

ON THE SECTION 89 ISSUE

MAY 2, 1989

Mr. Chairman and members of the Committee, I want to thank you for this opportunity to share my views with you today.

I want to take a moment to describe some of the specific problems pertaining to Section 89 that the business people in my state have relayed to me. In addition, I would like to make a brief statement about my bill, S. 595, the "Section 89 Small Business Relief Act of 1989."

May 1 Secretary Brady ordered a delay in the July 1, 1989 effective date of the law until October of this year. This will provide relief for employers across the country, but it is not enough. I mention this because it is an indication of the Administration's willingness to work with Congress to fix the law.

I would like to begin by applauding Chairman Rostenkowski for his outstanding effort to simplify Section 89. Without a doubt, H.R. 1864 is step in the right direction toward reform. I am particularly pleased that the Chairman has included a provision that is included in my bill, that would raise the standard of coverage from 17 and 1/2 hours to 25 hours for part-time employees. This is crucial to employers who have a number of part-time employees.

However, this Senator feels strongly that we have a ways to go toward our goal of simplification. I do not believe the this bill goes far enough and I will continue to support additional modification measures to ease the burden of this law on the business men and women in this country.

Section 89 was enacted as part of the Tax Reform Act of 1986. With few exceptions, this law requires all employers who offer benefit plans to conduct a series of complex statistical tests to ensure these plans are distributed fairly among all their employees, whether they are highly compensated executives or whether they are rank and file workers.

Mr. Chairman, with 25 million uninsured workers and workers' families in this country, encouraging private insurance coverage is a worthwhile goal. I don't think there is anyone here who would disagree with the intent of Section 89.

The problem is that small businesses, experts in benefit programs, accountants, and attorneys are all finding that they are unable to figure out the rules necessary to comply with the new law.

Approximately two months ago, on March 2, the IRS published regulations to implement Section 89. Those regulations consist of 200 pages of rules for the business people of this country to grapple with. But those 200 pages of rules, confusing as they may be, are nothing compared with the confusion caused by the statute itself.

I am encouraged by the IRS's efforts to clarify this monster known as Section 89. However, employers are still left wondering what they are required to do to comply with the law this year.

In fact, many employers have exhausted every source of information available to them, and now they have begun to telephone my office to see if I can offer them any guidance on whether their plans are in compliance with the law.

Mr. President, these are law abiding taxpayers who want to comply with the law. But they can not comply because no one can tell them how. I certainly can't. And I find that situation astonishing and frightening.

Last week I held a "Section 89 Forum" in New Mexico. Albuquerque is a relatively small city, but over 300 people came to share their views and frustrations on this issue.

I was astounded by what I learned. Even with benefits experts, insurance agents, lawyers, and accountants, it is impossible for the employers in my state, or any other state, to get advice that is 100 percent accurate.

Nevertheless, the employers in my state are going to great extremes to comply with this law. I learned in this meeting that for $3,000, plus $20 per employee, "Section 89 benefit testers" will let employers know if their plans are in compliance. Many businesses have already invested large sums of money to comply, and now it seems certain that we in Congress will change the law. I applaud that change. Employers will be glad to know that they may not have to go to this same trouble next year.

One small business owner told me that she was approached by a company that offered to sell her Section 89 software packages for $4,000. $4,000 for one piece of software! There was one catch though. She had to buy it before the end of this month, or the price would increase.

So long as the thrust of the law remains in tact, I do not believe new rules, regulations or legislation that makes only minor changes in the law will do much to aid compliance significantly. At best, they leave many unanswered questions and raise new problems for employers who are making decisions concerning employee benefit plans.

I have spoken with many business owners in my state as well as business groups here in Washington. The consensus is clear: Congress should repeal or significantly modify Section 89.

I have received many letters from the business people in New Mexico and elsewhere in the United States. It seems there are two types of letters. Some business people say they are aware of Section 89 and they are flabergasted and outraged. Others aren't even aware of the law or its ramifications.

One small businessman said that he had studied the meaning of the law very carefully and decided the best way for his business to cope would be to drop the company-sponsored health plan and raise everyone's salary by $100 a month. That would allow the employees to decide for themselves whether or not they want to purchase their own coverage or, as this businessman put it, "spend the extra $100 on beer."

Another employer told me "we know we'd pass the tests, but it would cost thousands of dollars and thousands of wasted man hours just to prove it."

One small business woman wrote "we have elected to let sleeping dogs lie. We will not be following through on plans to offer group insurance to our employees. We are very disappointed to have to make that decision. It was a service we wanted to provide."

These comments may sound extreme, but they are comments I have heard over and over again. They provide a very accurate illustration of the frustration employers in this country feel.

Mr. Chairman, Section 89 is poor policy, by anyone's judgement. The more I learn about Section 89, the more I think the tax writers set out to correct a perceived wrong in the existing Tax Code.

I am told by many members of the Chamber of Commerce in Albuquerque that in most cases if businesses can afford to offer benefits to their employees, they offer them to all their employees.

Most small businesses already offer comprehensive benefit plans. Instead of encouraging this, Section 89 serves as a hindrance. The requirements of this law place an unfair burden on all businesses, but especially small businesses because they don't have the resources to deal with the paperwork and compliance issues.

I am aware of an analysis prepared by OMB that estimates it will take approximately 10 hours per firm to comply with Section 89. From what I have heard from the business people in my state, this estimate is ludicrously low. It will take more time than that for them to just read through and understand the 200 pages of regulations, much less collect the necessary data, and perform the testing computations.

I, along with many of my colleagues in the Senate and the House, are concerned that Section 89---even with the regulations---will achieve the opposite effect of what it was intended to do. Employers will be forced to spend exorbitant amounts of money to comply with the law. This is money that they would rather spend on benefits for their employees.

I think that Congress and the Administration are beginning to see the problems associated with Section 89. Treasury Secretary Brady's recent decision to delay the effective date of the law, and the impending penalties, is testament to the fact that the law is flawed.

There are many in Congress who would like to scrap the entire law and start from scratch. I hope we do not have to go to that extreme, but we may.

In 1987, 88 percent of all businesses in my state had fewer than 20 employees. Thus, legislation directed at expanding coverage for the working uninsured must focus on the small business sector because in large part, that is where the problem is most pervasive.

Secretary Brady appeared before the Appropriations Subcommittee on Treasury, Postal Service, and General Government, of which I am the Ranking Republican Member. At this time I explained to him the particular problems Section 89 creates for small businesses. He agreed that an exemption for small businesses, such as the one I have created in my bill, may be necessary.

The bill that I have introduced proposes some very basic changes that will help relieve the burden of this law on small businesses. Briefly I would like to tell the Committee members about my bill. S.595 would make the following changes:

1. Exempt all small businesses consisting of fewer than 20 employees from Section 89 altogether;

2. Implement a 25-hour standard for part-time employees;

3. Delay the effects of the law for two years;

4. Provide that employers who offer benefits to all employees are in compliance with the law regardless of whether or not the employee chooses to participate in the benefit package.

Mr. Chairman, I would like to thank you and the members of this committee for giving me this time to voice my concerns about Section 89. I will look forward to working with my colleagues to restore fairness to the law.

Electronic Industries Association

May 12, 1989

Honorable Dan Rostenkowski
Chairman
Committee on Ways & Means
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Chairman:

The Electronic Industries Association (EIA) is pleased to present its views to the Committee on Ways & Means concerning H.R. 1864, a bill to reform §89 of the Internal Revenue Code. We submit these views for insertion into the printed record of the hearing held by the Committee on this subject on May 2, 1989.

EIA is the oldest and largest trade organization representing manufacturers of electronic products for defense, telecommunications, component and consumer-end uses. EIA member companies produce approximately 85% of the U.S. electronics industry's $244 billion in annual sales. As such, we have a strong interest in promoting flexible, cost-sensitive human resources policy.

We wish to commend you and the cosponsors of H.R. 1864 for taking a fresh look at the goals and structure of §89. We believe H.R. 1864 represents a major step forward in the debate over §89 and we look forward to continuing to work with you.

Indeed, many of our members are concerned that reform efforts will not achieve stated policy goals if they are encumbered with restrictions which make it impossible for employers to provide health care benefits whose costs can be anticipated, projected and afforded on a consistent basis. From the beginning, we have been concerned that §89 and its regulations appeared to foreshadow the imposition of qualified health plan rules that would create the same problems as we have experienced with the qualified pension plan rules -- increased complexity, constant change, and greater compliance costs.

While several key issues of interest to EIA have been addressed by H.R. 1864, many others remain. Among them -- but certainly not limited to -- are:

1. Cafeteria plans. Many EIA members evidence a deep concern with the treatment of cafeteria plans in H.R. 1864 (particularly those that involve the use of salary reduction). Under the bill, amounts funded through salary reduction are treated as employee contributions for purposes of determining whether a plan satisfies the requirement that employee contributions equal no more than $10.00 per week for individuals and $25 per week for family coverage. Salary reduction is also treated as an employee contribution in setting the base amount that is multiplied by 133% to determine the maximum limit on nondiscriminatory benefits that can be received by highly compensated employees.

By contrast, however, in determining the amount actually received by a highly compensated employee, salary reduction amounts are treated as employer contributions. Therefore, when determining whether the 133 percent limitation on tax-favored employer-provided contributions is met, salary reduction is included.

We think this treatment of salary reduction is unnecessarily harsh. If salary reduction is deemed to be based on either employee or employer contributions for one purpose (determining the base), then it should logically be deemed to be based on that same type of contribution for other purposes (determining the amount of employer contribution that is subject to tax.) Certainly a salary reduction plan should not be faced with tests that are contradictory and provide the most disadvantageous result in each case.

The practical effect of such an approach is that employers with salary reduction plans can offer the same benefits to their employees as employers with non-salary reduction plans; but the former's plan may be discriminatory and the latter's may not be.

A practical problem stemming from this contradictory treatment of salary reduction as all employee-provided (except for determining the discriminatory portion) is that an employer who wants to provide access to some health benefits, but who for economic reasons must shift a significant part of the cost to employees, cannot do so by salary reduction.

In particular, the inability to use salary reduction to determine whether the family coverage meets a core benefit requirement may be a significant problem for many employers. It is in that case that employers (particularly those who have employees with two incomes) often like to make family coverage a choice for employees that is paid for under a salary reduction arrangement.

We recognize that the tax policymakers may have some concern about a system that uses salary reduction to the point of allowing higher-paid employees to purchase coverage on a tax-favored basis that is not, as a practical matter, available to the lower-paid. But this is not the reason why salary reduction is provided, particularly in a cafeteria plan. Salary reduction is usually provided as a means to allow employees to choose additional, more costly features at their own election, or as an alternative to other benefits.

Employees may want to pay for these features because they are important in particular family circumstances, but employers may be unwilling to provide them in a nondiscriminatory manner to all employees. In fact, employees who do not need certain expensive benefits would resist their being offered if it meant that all employees' salaries and/or benefits would decrease.

We respectfully suggest that the harsh treatment of salary reduction in H.R. 1864 may cause some employers to reexamine whether they want to offer such features in cafeteria plans. This would be unfortunate. Cafeteria plans with salary reduction features offer an important and necessary alternative to a rigid employer-provided plan that tries to serve everyone and ends up serving no one.

Many of our employers are enthusiastic about cafeteria plans because they allow employees with different needs to choose a benefit that best suits them. This is particularly important for employers in high technology industries because of the keen competition that exists in the employment marketplace for qualified, highly-trained technological personnel.

Moreover, we believe that highlighting the choices offered to employees makes the employees more cost conscious and, as a result, better consumers of health care. Flexible benefits, in short, are among the most cost-effective and the most popular in the electronics industry because they allow employees to choose those benefits which best suit their individual needs.

Therefore, we urge the Committee to consider alternative measures for treating salary reduction in H.R. 1864. We believe that salary reduction ought to be treated as an employer provided benefit because it, in essence, is a benefit provided in lieu of current wages that an employee chooses (under the requirements of the cafeteria plans rules) to use for health care. (If that were the case, then many salary reduction plans would likely be able to meet the $10.00/$25.00 minimum benefit test set-forth in the statute.)

If, alternatively, the Committee feels it must resist treating salary reduction as an employer provided benefit because it wants to make sure that some of the "core" health benefit to be provided at direct employer expense, then it should treat salary reduction as employee contributions for all purposes. This latter solution has a possible problem noted in the Joint Committee staff pamphlet, i.e., as long as a health benefit is provided to employees absent salary reduction, salary reduction can be used to provide much more generous benefits for those who do not need the cash alternative. But in that case it should be noted that at least the employer is providing a core benefit (without salary reduction) to a significant number of lower-paid employees.

Recognizing that consistency on either side of the question may cause policy problems, a Solomon-like decision might be to deem some portion of the salary reduction benefit as employer provided (e.g., the first $10 or half). Another alternative is to allow employers with salary reduction plans to continue to use the rules of section 89 for a period of longer than one year. Since this would not achieve your desired goal of simplicity, it might be possible to devise a simple additional nondiscrimination rule on cafeteria plans that use salary reduction, thus preventing the grant of tax-favored salary reduction benefits to plans that do not provide meaningful access to the rank and file employee.

2. The 90% test. One of the nondiscrimination tests under present law is that core health benefits must be available to at least 80% of the employer's non-highly compensation employees. H.R. 1864 would increase that threshold to 90%. EIA believes that the increase in the participation threshold from 80% to 90% is too high. In brief, we are concerned that when the 90% standard is combined with a number of the bill's other provisions -- particularly its treatment of leased and former employees and its elimination of the separate testing rule -- many employers who offer broad-based health plans to their employees will not be able to meet the 90% standard.

For example, the intense global competition facing many electronics manufacturers is such that many companies must hire temporary employees for limited periods of time in order to meet peak work load demands. If such peak periods coincide during a test date with a 90% participation requirement, a plan could fail the test. The 80% threshold will be sufficient to cover changes in hiring practices due to changes in the business cycle and safeguards could be provided to prevent abuses. This is particularly important for companies which have short or no waiting periods for medical coverage for permanent employees and who therefore cannot utilize the six month exclusion rule.

Moreover, the penalty for failing this more stringent availability test is significantly increased under H.R. 1864. Under the bill, the highly compensated are fully taxed on the value of their health coverage if the plan fails the availability test. By contrast, under current law, only the discriminatory portion of the highly compensated employee's benefit is included in income. H.R. 1864 thus exacerbates the so-called "cliff effect"; that is, the impact on highly compensated is the same whether the benefits are available to 89% of non-highly compensated employees or 19% of such employees.

3. 133% Test. The bill replaces the current 75% benefits test with a provision that allows a highly paid employee to exclude from income employer-provided coverage of an amount up to 133% of

the smallest employer-provided coverage that is available to non-highly compensated employees and that is used to satisfy the 90% test. If this test is not satisfied, all employer contributions, including salary reduction contributions, that are in excess of 133% are included in the highly compensated employee's gross income.

Although this test purports to be the reciprocal of the current law 75% benefits test, it is much more difficult to pass, since it is keyed off the smallest employer provided benefit rather than the average benefit, as is the case with the 75% test, and is applied to each highly compensated employee individually.

We submit, therefore, that this 133% figure is too low. For example, the 90/50 test of current law allows an employer to offer highly compensated employees a benefit of up to 200% of the minimum benefit available to 90% of the non-highly compensated employees, and supplements this test with the 75% test to limit the average benefits used by all employees. We do not suggest the introduction of additional tests; we merely use this as an example to illustrate that the 133% test may be too low, and suggest that a percentage closer to 200% may be more appropriate.

4. Indexing. Maximum employee premiums are indexed to wage inflation under H.R. 1864. We believe that in order to maintain a meaningful allocation of health care costs between employers and employees, maximum employee premiums should be indexed to the medical component of the Consumer Price Index.

5. Leased Employees. While the bill provides that leased employees do not have to be counted if the leasing company makes affordable core health coverage available to its employees, the bill fails to provide clear guidelines as to who, in fact, constitutes a leased employee. Compounding this, proposed Treasury regulations have gone beyond the intent of Congress to treat as leased employees many individuals who never were intended to be covered. EIA believes that any reform effort must provide that leased employees will not be taken into account until plan years that begin at least one year after publication of final employee leasing regulations.

6. Former Employees. Application of the rules pertaining to former employees is delayed under the bill for a one year period. It is our view that §89 should not apply to former employees until Congress fashions appropriate rules for them. We urge that former employees be excluded from testing entirely or at least until such time as a Congressional study of the issue can be completed. In any event, we believe the treatment of former employees should be dealt with in statutory -- rather than regulatory -- language.

7. Part-time Employees. H.R. 1864 increases the cutoff point for part-time workers from the unrealistically low level of 17 1/2 hours per week to 25 hours per week. EIA believes that the improvement made by H.R. 1864 must go even further. Specifically, our view is that a 30 hour per week threshold would be far more reasonable and workable for employers. Such an adjustment would help avoid the undesirable consequence of such things as small companies simply decreasing part-time employment opportunities in order to avoid §89 penalties.

8. Separate Lines of Business. The Tax Reform Act of 1986 provided separate line of business and separate operating unit provisions for new coverage and nondiscrimination requirements applicable to both pension plans and §89-covered employee benefits. To be able to use these provisions, companies must be able to rely upon guidelines set forth by the Internal Revenue Service or upon a ruling or determination letter from the IRS.

Notwithstanding the fact that the separate line of business provisions became effective this year, the IRS has not yet issued necessary guidelines or regulations. Compounding this problem, the Service has also failed to issue rulings or determination letters on separate line of business and separate operating unit issues. Any meaningful reform must recognize the importance of these provisions to the new coverage and nondiscrimination rules and should provide immediate relief from this problem.

9. Definition of "Qualified Core Health Plan". Because H.R. 1864 uses the term "qualified core health plan", EIA believes any reform legislation must include a statutory definition in order to prevent the IRS from defining such in regulations. There are several such definitions available in other existing statutes. For example, the Committee could consider using the COBRA definition in order to clarify the term in H.R. 1864.

10. Accidental Death and Dismemberment and Business Travel Accident Coverage. Proposed IRS regulations for §89 deem accidental death and dismemberment (AD&D) and business travel accident (BTA) benefits as health benefits under §89. This makes little, if any, sense. AD&D is almost always provided in some proportion to an individual employee's compensation -- that is, it is a benefit offered directly in proportion to pay. §89 reform efforts should set forth that AD&D is not considered discriminatory provided companies provide it in proportion to an employee's pay.

11. Valuation. The value of health plan coverage is to be determined by the Treasury through regulation. §89 reform efforts should set forth -- in statutory language -- specific valuation options. For example, employers should be able to use premium cost or other reasonable valuation methods in complying with §89 requirements. In this regard, we note that this general approach is being permitted on a temporary basis under the proposed IRS regulations.

12. Effective Date. EIA supports a delay in the effective date of the proposed regulations, especially those relating to the qualification requirements, until six months after publication of final regulations.

We thank you for the opportunity to submit our views for the record and look forward to continuing to work with your staff on this important issue. Should your staff wish further information on our views, please have them contact Kevin Richardson, Staff Vice President of Government Relations, at 457-4925.

With every good wish, I am,

Sincerely,

ELECTRONIC INDUSTRIES ASSOCIATION

PETER F. MCCLOSKEY
President

/kcr

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May 17, 1989

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
United States House of Representatives
Washington, D.C. 20515

RE: Comments for the Record of the Hearing on H.R. 1864

Dear Mr. Chairman:

I represent a number of local government agencies, institutions and businesses who have bargaining unit employees. We are grateful to you for introducing H.R. 1864 which solves many of the problems posed by Section 89 of the Internal Revenue Code. Because I know that you are fully briefed on the myriad number of difficulties created by Section 89, I will address in this letter only three specific points about the impact of Section 89 upon employers who make contributions to multiemployer health plans on behalf of their bargaining unit employees. In general, we support H.R. 1864. If enacted, the bill will go a distance to solve the many problems created by current law. Nevertheless, I hope the committee will consider the following points as it refines the bill.

1. The separate testing provision for union employees in H.R. 1864 will cause fewer statutory employee benefit plans to fail the nondiscrimination requirements. In general, an employer makes lower contributions to a multiemployer fund on behalf of its union employees. Section 89 requires mandatory aggregation with respect to the 90%/50% eligibility and 75% benefits tests. Therefore, with respect to these tests, an employer is forced to aggregate its non-union plans together with the multiemployer plans to which it contributes on behalf of its union employees. Because lower contributions are sometimes made on behalf of employees covered by multiemployer plans, an employer who contributes to these plans stands a substantial risk of failing the nondiscrimination requirements. H.R. 1864 will prevent an inappropriate comparison between contributions made on behalf of union and non-union employees. Thus, the "separate testing" provision in the bill alleviates the problem of "comparing apples to oranges" that results from present law. As a result, the bill will cause fewer statutory employee benefit plans to fail the nondiscrimination requirements.

H.R. 1864 recognizes that an employer's statutory employee benefit plans should not fail the nondiscrimination tests merely because the employer made lower contributions to a multiemployer fund than it contributed to plans covering non-union employees. An employer may make lower contributions to a multiemployer fund because such contributions are negotiated in good faith between the employer and the union and because many other employers are also contributing to these funds. Despite these lower contributions from a particular employer, the beneficiaries of multiemployer plans often receive better benefits than other employees. The collective bargaining process prevents discrimination against union employees and provides a sufficient safeguard against the type of favoritism that Section 89 was meant to stop.

H.R. 1864 will once again permit employers to treat collective bargaining agreements with the respect these agreements deserve. After all, the collective bargaining agreement is a contract. The law has traditionally recognized that contracts created in good faith deserve protection. Because Section 89, as presently written, prevents the collective bargaining process from determining benefits that are to be conferred upon union employees, it undercuts the sanctity of collective bargaining agreements and is contrary to well-settled labor policy. H.R. 1864 represents a major step toward correcting this feature of current law, and further amendments to the bill should honor the traditional place of collective bargaining in American labor relations.

2. Contributions on behalf of bargaining unit employees should not have to be taken into account for purposes of the nondiscrimination requirements. Although H.R. 1864 solves a major problem posed by the current Section 89, it leaves another burdensome provision intact. Even under this measure, contributions to union employees must still be accounted for. Accordingly, even though union employees are separately tested under the bill, if highly compensated union employees receive better benefits than other union employees, the employer may fail the nondiscrimination requirements.

Engineers, for example, are often highly-compensated bargaining unit members. Employers and unions should be permitted to negotiate higher contribution levels for these employees if they wish. However, under present law, if an employer makes higher contributions on behalf of union engineers that create an impermissible imbalance when compared with contributions on behalf of other bargaining unit employees, there is no way to correct this imbalance before the bargaining agreement expires without incurring significant penalties. This feature of present law would remain intact even if H.R. 1864 is enacted.

In addition, as mentioned above, contributions made to a multiemployer fund are the results of collective bargaining and good faith negotiation. The collective bargaining process ensures that impermissible discrimination does not occur. Therefore, that process should be the ultimate method of safeguarding the interests underlying Section 89. H.R. 1864 would be a stronger bill if it provided that union employees should not have to be taken into account for purposes of the nondiscrimination requirements.

3. The bill's separate testing provision is too narrow. H.R. 1864's separate testing feature does not apply in pertinent part if an employer has a collective bargaining unit that includes more than a de minimis number of engineers or architects. Because many employers have collective bargaining units that include more than a de minimis number of highly compensated engineers or architects, many employers who would otherwise benefit from the bill's separate testing provisions will not be able to test separately. If these employers cannot test separately, they will fail the nondiscrimination requirements. Thus, we urge that the bill be amended to broaden the separate testing provision.

Your interest in addressing the problems posed by Section 89 is encouraging. I commend you for introducing H.R. 1864 and promptly scheduling the hearing on this important remedial legislation. As my associate discussed with the committee staff, this letter constitutes my comments for the record of the hearing that the committee recently conducted. We are grateful for your consideration. If I can be of service to you or to the committee staff, please let me know.

Very truly yours,

Terrence M. Finn

Terrence M. Finn

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May 5, 1989

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Leonard:

HR 1864, the new Section 89 bill, has some very adverse consequences to employers with Section 125 cafeteria plans. A simple example shows how the bill's simplification produces unfair results:

> Assumptions: 100% of non-excludable employees are eligible to participate in a health plan providing core benefits. Employee coverage is non-contributory. Family coverage is available through employee premiums of $15 per week as part of a cafeteria plan in which employees can elect to contribute through salary reduction. (For simplicity, assume all employees are married and all employees elect this coverage.) Family coverage has a total cost of $40 per week.
>
> Current Section 89 Rules: All tests are satisfied trivially, because there are no differences in coverage or utilization.
>
> Proposed Section 89 Rules: The highly compensated employee is considered as having $40 weekly employer-provided benefits, even though $15 is funded with salary reduction. The non-highly compensated employees are treated as having $25 a week in employer-provided benefits. The 133% rule would thus mean the highly compensated employee has $6.75 in taxable health benefits each week and any other health benefits would be fully taxable.

Treating salary reduction benefits as employer-provided for highly compensated (but employee-provided otherwise) is intended to keep employers from establishing high premiums for salary reduction benefits that will not be utilized by most employees. As the above example shows, a clearly non-discriminatory plan results in taxable compensation nonetheless.

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A better approach is to treat the amount of salary reduction contributions required for primarily core health benefits as employee-provided. Under HR 1864 these amounts cannot exceed $10 for single or $25 for family coverage. In the above example, all employees would then have $25 of weekly employer-paid benefits. If other benefits were made available to all employees (voluntary dental, vision care, Section 125 reimbursement accounts, etc.), the highly compensated employee would be limited to a modest $8.33 (33% of $25) of such other weekly non-taxable benefits.

We urge you and your colleagues to take a very careful look at Section 89 revisions. We applaud the objective of simplifying Section 89, but we oppose a change in policy that adversely affects Code Section 125 plans.

Sincerely,

Robert A. Hamilton
Vice President & Trust Officer
Employee Benefits Manager

STATEMENT OF GEORGE R. GREEN, VICE PRESIDENT AND ASSISTANT GENERAL COUNSEL, FOOD MARKETING INSTITUTE

The Food Marketing Institute (FMI) appreciates the opportunity to present its views on H.R. 1864, a bill designed to simplify the nondiscrimination rules applicable to fringe benefit plans under Section 89 of the Internal Revenue Code.

FMI is a nonprofit association conducting programs in research, education and public affairs on behalf of its 1,600 food retailer and wholesaler members. FMI's domestic member companies operate approximately 17,000 retail food stores with a combined annual sales volume of $180 billion--more than half of all grocery sales in the United States. Three-fourths of FMI's retail membership is composed of small regional firms and independent supermarkets. Its international membership includes more than 200 members from over 50 nations.

It is now generally recognized that Section 89 as currently written is unreasonable and actually counterproductive to the goal of nondiscrimination in fringe benefits coverage. FMI believes that, if Section 89 is not repealed, it must be totally revamped. H.R. 1864 is an important step in that direction. With necessary modifications it could serve as a meaningful reform to Section 89. FMI thanks the chairman and the other cosponsors for their willingness to take on this important task.

The problems with Section 89 are well-documented. However, it is important to understand the specific difficulties caused by Section 89 in order to make reform proposals meaningful. Section 89, we believe, is especially burdensome, and unfair, to food retailers and wholesalers, and their employees. This is because our industry's work force is characterized by a large proportion of young, part-time, and high turnover employees. The nature of our work force, along with the structure of the industry, make Section 89's testing requirements an impossible burden for the food distribution industry. Reform proposals need to be considered in the context of this work force to assure that all employers are treated fairly by the ultimate resolution of this issue.

The Food Distribution Work Force

A recent FMI survey documents the transitional nature of the work force in the food distribution industry. Respondents to the survey operated over 10,000 stores and employed more than one million workers. Fifty-four percent of those employees work part-time. At store level, about two-thirds of the work force is part-time. This part-time work force is extremely young. Sixty-one percent are under 21. Eighty-nine percent are 25 or younger. This reflects the many entry level job opportunities in the industry and the fact that many of these part-time jobs are filled by students and temporary personnel. This makes for a more unstable, mobile work force, resulting in high worker turnover. Our survey showed the annual turnover rate for part-timers to be 69 percent. In other words, more than two-thirds of the part-time work force turns over every year.

The Benefits

FMI's survey showed our industry offers generous benefit packages to its full-time employees. Ninety-seven percent offer health insurance to salaried and hourly employees. More than half the employers pay the entire premium for medical insurance. Seventy-five percent offer dental coverage to salaried and hourly employees. Over ninety percent of those offering dental coverage pay the entire premium. Sixty-eight percent offer short-term disability coverage to salaried employees; 69 percent to hourly employees. Ninety-five percent offer life insurance to salaried employees; 93 percent to hourly employees. About three-quarters of those pay the entire premium. Seventy-two percent offer pension plans to salaried and hourly employees. Over 90 percent pay for the entire contribution to the pension plans.

Additionally, many workers in our industry are represented by unions. Union members accounted for 54 percent of chain store workers nationwide in 1987, and for over 75 percent in the North Atlantic and Western regions. The benefits offered unionized employees are bargained for and agreed to by the employees' representatives.

Moreover, in most cases in our industry, the health and welfare plans, as well as the pension plans, for unionized employees are multiemployer trusts, jointly administered by the trustees representing the union and the participating company managements. These multiemployer plans are regional in nature and are linked to specific job classifications. A food retailer operating in just one metropolitan area may, for example, contribute to a meat cutters plan, a retail clerks plan and a teamsters plan (for its truck drivers). A company operating in several metropolitan areas would contribute to several different plans in each of the areas in which it operates. A chain operating in many different metropolitan areas would be involved in many different plans.

The Problems

The problems Section 89 creates for food distributors in the context of all this should be obvious. First, and foremost, the data collection requirements are monumental and costly. The large number of part-timers coupled with the high turnover rate makes it extremely difficult, and sometimes impossible, to compile the necessary data to comply with Section 89. Many questions must be resolved before a company can even determine the basic question of which employees must be included in the tests.

Here are just some of those questions. How many employees are under 21? How many work 17-1/2 hours per week? How many have been on the job six months by the testing date? How many are in collectively bargained plans? Multiemployer plans? Who qualifies as highly compensated? How many are divorced, or married vs. single? How many are covered by a parents or spouse's plan? All this data must be collected and maintained on an ongoing basis, at a substantial cost, before testing even begins, and for a work force 70 percent of which will be gone before the year is out.

To do the testing, a whole new layer of information about the plans offered must be gathered. Each plan must be evaluated and valued to determine whether or not they are comparable. Section 89, of course, considers each benefit option to be a separate plan. Aggregation is permitted in some cases, but not in others. This means minor differences in plans (such as different waiting periods) must be measured, valued, compared and tested. Rules designed to aid employers, such as the line of business and comparability rules, only add to the complexity. Even the smallest food distributor is quickly overwhelmed by the bewildering complexity of determining who and what is comparable to whom and what else.

For larger companies in our industry too, the task is overwhelming. One regional food chain has some 50,000 employees who are covered by two non-union plans and 374 collectively bargained benefit packages. This equates to approximately 900 separate plans, administered through 27 trusts, or administrators.

To compound the problem, employers in multiemployer plans have no direct control over the union plan documents, limited access to such documents, as well as little or no influence to regulate or change the plans in order to comply with Section 89.

For all these reasons, food retailers and wholesalers have been unable to begin to attempt to comply with the Section 89 testing requirements.

H.R. 1864

H.R. 1864 addresses many, but not all, of these problems. It simplifies testing considerably by shifting the focus from plan participation to plan design and by eliminating the need to test every different plan option offered. Also the shift in focus from benefit value to benefit cost is extremely important. Modifications to H.R. 1864 are necessary, however, to assure that unnecessary complexity is not still retained, and just as importantly, to ensure that non-discriminatory plans do not fail the remaining tests because of inadvertent drafting. The following are some of the areas which should be addressed:

- The 90 percent test. H.R. 1864 requires that 90 percent of all non-highly compensated (NHC) employees be eligible for core coverage. This is much too restrictive. Employers will be unable to meet this test, even in cases where the vast majority of NHC employees receive coverage. We suggest that a 70 percent test be used instead of 90 percent. A 70 percent limit is in line with standards applied by the Employee Retirement Income Security Act (ERISA) to pension plans. It would permit reasonable accommodation to the demands of a complex work force.
- Part-timers. H.R. 1864 excludes employees who normally work 25 hours a week or less. This level, while preferable to existing rules, is still too restrictive. The bill permits a pro rata adjustment for employees working between 25 and 30 hours. This adjustment is far too complex to be workable. We suggest a change to exclude employees who normally work less than 30 hours per week. The 25 hour limit is inconsistent with industry customs as to benefits for part-time workers. In the food industry, employees working fewer than 30 hours are typically not provided fringe benefits. (This does not mean they lack health coverage. In most cases, they are covered by parents' or spouse's plans.) In organized companies, the definition of "part-time" and the benefits provided to part-time employees are issues that are negotiated and agreed to with the union.

As policy, the part-time rule causes problems. The stated purpose of Section 89 is to prevent discrimination in benefits. Inclusion of part-timers in the rule's coverage, however, is really an effort to mandate benefits for part-timers. If that is a desirable goal, which we strongly dispute, it should be addressed directly through mandated health insurance legislation.

- Excluded Employees. Under the bill, as under Section 89 originally, several categories of employees, such as those under 21 or those on the job less than six months, are excluded from testing. That is, they need not be counted in determining whether the eligibility test is met. However, these employees may only be excluded if three requirements are met:
  - no excluded employee can be covered by any plan;
  - all plans must exclude the excluded group; and
  - the plans must exclude the group by their terms, not solely in operation.

These rules severely limit the availability of the exclusions, and do so in a way that will actually discourage coverage of the excluded categories of employees. The requirement that the category be excluded by each and every plan is impractical, because different employer plans will vary, in reasonable ways, to accommodate different work forces. For example, a plan for distribution center employees will differ from a plan for retail clerks, or a plan in New York City will differ from one covering employees in Mississippi. It would be extremely unfair, and counterproductive, if food distribution employers were required to count every employee in an otherwise excludible category just because another plan offered to other segments of the work force provides coverage to that group. If there is a concern that some excludible employees could be included in a plan on a discriminatory basis, this could be handled by the discriminatory terms tests.

- The Index. Employee costs for health insurance are indexed to the social security wage index, a index which rises very slowly, especially in relation to health care costs. We believe a more appropriate index to use is the CPI for health costs. Health care inflation is an unfortunate fact of life. In recent years, it has far exceeded the general rate of inflation. Employer costs will be rising at the rate of change for health costs; employers should be able to have employee contributions keep pace. Without an adjustment to this index, in just a few years employee contributions, which play an important role in health care cost containment, will wind up being disallowed totally.
- Union Employees. H.R. 1864 requires that union employees be tested "separately". While certainly an improvement over current Section 89 (a), there is uncertainty over how this will be applied. Moreover, this rule fails to recognize that union employees are subject to different workplace conditions than are non-union employees. We believe that union employees simply should be excluded from Section 89. An alternative approach is to count union employees in determining whether the 90% test is met. All union employees in collective bargaining units with health plans should be deemed to be receiving core coverage under Section 89.

The nation's labor policy permits employees and employers to determine the wages and other benefits of employees through collective bargaining with only minimal restraint. Unlike any other law regulating benefits, Section 89 interferes with this process by regulating the benefits provided to union employees. The interference is plain: union employees may concentrate their negotiating power on wages, knowing that Section 89 will force the employer's hand on health and life insurance benefits. The interference is unprecedented: ERISA itself, the most complex regulation of benefits, excludes union employees from discrimination testing. See Code Section 410(b)(3), Section 401(a)(26)(D).

- Multiemployer Plans. As noted above, many employers in the food industry participate in several multiemployer plans, for several local unions. Larger employers may be in hundreds of plans. Under Section 89(k), these employers, who have little or no role in administering the plans, must police compliance of all plans with Section 89(k), in order to avoid penalty. This burden far outweighs any benefits, especially as ERISA itself requires extensive reporting and disclosure for multiemployer plans. At a minimum, the responsibilities and sanctions under Section 89 should fall on the person responsible for the plan. In the case of multiemployer plans, this is the plan administrator. The Consolidated Omnibus Budget Reconciliation Act's (COBRA) continuous health coverage provisions recognize this fact and place responsibility for implementing the law on the multiemployer plans themselves. We urge that this approach be followed here.
- Leased Employees. Leased employees simply should be excluded from Section 89 eligibility requirements. The definition of a leased employee is highly controversial and Section 89 should defer coverage of this group until that question is resolved.
- Effective Date. We believe the effective date of any reform bill should be one year after the IRS issues final regulations. The current chaos over Section 89 demonstrates vividly the need to assure that adequate time is allowed for employers to be educated about their responsibilities under Section 89. Even the best intentioned employer can't comply with law when it doesn't know what the law is. Rules permitting compliance in "good faith" are of no help when there is no clear law. Current Section 89 must be repealed pending the effective date of the new law. The approach in H.R. 1864 which asks employers to choose between current Section 89 and the new Section 89 for this year is unacceptable.
- Penalties. The penalties for violation of the Section 89(k) qualification rules are extremely onerous. The excise tax penalty is greater than the corporate tax rate. A more reasonable penalty should be adopted.

FMI urges that appropriate modifications, as discussed above, be made to H.R. 1864. We look forward to working with the Committee to assure that meaningful reform of Section 89 is enacted into law.

General Motors Corporation

JAMES D. JOHNSTON
VICE PRESIDENT

May 17, 1989

The Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

General Motors applauds the introduction of H.R. 1864 and your efforts to simplify the nondiscrimination rules for health and other employe benefit plans contained in Section 89 of the Internal Revenue Code. H.R. 1864 is a major step forward and would significantly reduce the record-keeping, data collection and testing requirements (and related costs) of Section 89.

Although we support the objectives of H.R. 1864, we also believe that additional improvements could be made to the legislation to make it even more workable. Our comments are provided in the attached statement which is submitted by General Motors for the hearing record on H.R. 1864.

We would be pleased to discuss with you or your staff the issues raised in the statement or any other aspects of Section 89 and its proposed regulations.

Sincerely,

James D. Johnston

JDJ/tlh

Attachment

cc: Members of the House Ways and Means Committee

1660 L Street, N.W. Washington D.C. 20036

STATEMENT OF GENERAL MOTORS CORPORATION BEFORE THE WAYS AND MEANS COMMITTEE OF THE UNITED STATES HOUSE OF REPRESENTATIVES ON H.R. 1864

General Motors applauds the introduction of H.R. 1864 and the efforts to simplify the nondiscrimination rules for health and other employe benefit plans contained in Section 89 of the Internal Revenue Code of 1986.

The intent of Section 89 was to promote greater equity in the distribution of employment-related benefits among all employes. GM supports these policy objectives, but in our view, the current law and recently proposed regulations are far too complex, costly and difficult to administer. H.R. 1864 would test for discrimination on a benefit availability basis, rather than a benefits received basis, and significantly reduce these administrative costs of compliance by simplifying record-keeping, data collection and testing requirements.

As background, because of the vast size of our covered population and the wide range of programs we offer, GM is extremely interested in ensuring that the process of complying with anti-discrimination mandates is as simple and straightforward as possible. GM currently provides health care coverage to 2.3 million employes, dependents and retirees residing in all fifty states (close to 1 percent of the U.S. population). Our broad benefit plans include core health coverage through indemnity plans, preferred provider organizations, and over 120 health maintenance organizations (HMOs). In addition, noncore benefits, including dental, vision, hearing, and prescription drug coverage, are also provided.

Current Treasury rules require GM to test separately over 27,000 health care plans. We have seven employes working full-time on this project, as well as numerous others who are involved in implementation on a part-time basis. When data processing and record-keeping costs are included, we estimate total annual costs to General Motors will exceed one million dollars per year. These costs are too high and could be reduced through simplification efforts like H.R. 1864.

Although we support the objectives of H.R. 1864, we believe additional improvements could be made. We have prepared a summary of issues we hope will be considered to make H.R. 1864 even more workable. These issues are the following:

1. Leased employes are required to be included in Section 89 testing unless the safe harbor exception applies. The proposed I.R.C. 414 regulations regarding leased employes are over-broad and not administrable. Leased employes should not be required to be included in Section 89 testing until, at the very least, final I.R.C. 414 employe leasing regulations have become effective.

2. Accidental death and dismemberment benefits (AD & D) and business travel insurance remain subject to Section 89 testing in combination with health care. AD & D benefits are often compensation related benefits; they are similar in nature to life insurance. AD & D benefits should not be

included in Section 89 testing of health care plans. Also, business travel accident insurance is de minimis in value and is a form of life insurance, and should be disregarded.

3. "Former employes" would be subject to Section 89 testing in 1990. But former employes cannot be tested in the absence of an adequate definition of that term. No law or regulation definitions of a "former employe" have yet even been proposed. Testing of former employes also requires the gathering of additional and unique data. Testing of former employes should be delayed until final regulations governing former employes are published.

4. H.R. 1864 provides for a uniform testing date to be used by all members of a controlled group. Employers maintain separate lines of business that operate independently and have valid business reasons for selecting different testing dates for such lines of business. Employers with health care plans tested on a line of business or operating unit basis should be entitled to elect a separate testing date for each line of business or operating unit.

5. A de minimis or inadvertent failure to comply with the qualification rules would result in an excise tax on the employer. Provisions should be added to allow employers to take corrective action in order to avoid or reduce the excise tax.

6. For purposes of determining the taxable benefit under a plan meeting Section 89 eligibility requirements, plans may be aggregated if "each of [the aggregated] plans is available to the same group of employees ...". Proposed Section 89(b)(2)(C)(i). The scope of the phrase "the same group of employees" is unclear. For example, GM offers HMO coverage to all its employes where such coverage is available. But HMO coverage is usually limited geographically, e.g., an HMO in Michigan will be limited to all employes who are residents of the HMO's Michigan service area, an HMO with similar coverage in Ohio will be limited to employes who are residents of that HMO's Ohio service area, etc.

   We believe such similar HMO plans can be aggregated, but are concerned that the phrase "the same group of employes" might not be so interpreted. It should be clarified, either in the law or in the legislative history, that such geographical aggregation is permissible.

7. Section 89 should provide an exclusion similar to that contained in the Employe Retirement Income and Security Act 4(b)(4) [29 U.S.C. 1003(b)(4)] for plans maintained outside the United States primarily for the benefit of persons substantially all of whom are non-resident aliens. It is not feasible for U.S. businesses to monitor and test such plans.

8. Health care programs providing benefits of nominal value (e.g., wellness, screening tests, smoking clinic, weight loss, etc.) that are not directly supervised by a physician should be excluded from Section 89 benefit determinations if made available to all employes.

9. On-site medical offices providing only minor emergency services or referral services should be excluded from Section 89 benefit determinations if made available to all employes.

Again, General Motors supports the effort to simplify the nondiscrimination rules contained in Section 89.

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May 3, 1989

Honorable Dan Rostenkowski
Chairman
Committee On Ways and Means
1102 Longworth HOB
Washington, DC 20515

Dear Mr. Chairman:

As a cosponsor of H.R. 634 to repeal Section 89 of the Tax Reform Act of 1986, I am writing to express my interest in this issue and to request that my letter be made a part of the Committee Hearing Record.

I commend you, Mr. Chairman, for your response on this issue through the introduction of your bill to simplify the test rules and to hold these hearings on the impact of Section 89.

Every single employer, from state, local government, non-profit organizations, education institutions, as well as private sector business and industry has communicated with me about the devastating impact of Section 89 on their operations.

As you know, these provisions are so complex and difficult that Treasury did not even have any proposed regulations by the original effective date of January 1, 1989, and even the most sophisticated accountants have been unable to determine precisely how to comply with the law. It is certainly commendable that the Treasury Secretary has delayed imposing any penalties for noncompliance unil October, 1989.

Some businesses have spent enormous sums in an effort to make a determination on compliance with these extremely complicated tests. Indeed, a number of businesses have indicated to me that in the absence of some relief in this area, they will be forced to eliminate benefits which is absolutely counter to the intent of Section 89 to assure nondiscrimination among employees.

Again, I am most grateful to the Chairman for his foresight in pursuing timely hearings before the full Ways and Means Committee and in proposing a remedy for what has been called a "compliance nightmare" and "government gone crazy." We simply must provide relief to thousands of small businesses, and all other employers, who are pulling their hair out in trying to comply with this law.

I look forward to supporting a bill on the floor that eliminates this horrendous problem for employers. Congress must address this problem in a reasonable manner before the October 1, 1989, date for noncompliance penalties as now established by the Secretary.

With kindest regards, I am

Sincerely yours,

Bill Hefner

BILL HEFNER
Member of Congress

STATEMENT OF HERSHEY FOODS CORPORATION

COMMENTS ON REPRESENTATIVE ROSTENKOWSKI'S BILL REVISING SECTION 89 OF THE TAX CODE - HR 1864

Hershey Foods Corporation applauds Representative Rostenkowski's initiative to simplify the nondiscrimination testing provisions of Section 89 of the Tax Reform Act of 1986. In many respects, HR 1864 provides much of the relief for which we had hoped. In the case of conventional benefit programs which do not offer a choice to employees, the proposed rules eliminate much of the complexity of the original Section 89 rules.

We are concerned, however, about the impact of HR 1864 on our ability to continue to provide multiple option or cafeteria plans for employees. Specifically, the eligibility and benefits tests are inappropriate for multiple options or cafeteria plans.

- The $10 and $25 per week contribution limits cannot be met if so-called "salary reduction contributions" are considered to be employee contributions.
- The 133 percent test is manifestly unfair and impossible to pass if "salary reduction contributions" are treated as employee contributions for non-highly compensated employees and as employer contributions for highly compensated employees.

Currently all of Hershey Foods Corporation's salaried employees from the Chief Executive Officer down to mail room clerks and messengers are covered by a flexible benefit program providing significant choices for employees in the medical, life insurance and disability insurance areas. In addition, most of our hourly employees also enjoy the availability of two or more health plan options.

Hershey adopted these cafeteria plans to respond to the needs of our work force in a changing environment. Traditionally, our plans have been completely nondiscriminatory. In designing our multiple option plans, we made sure that they would not discriminate in favor of any group of employees, highly compensated or non-highly compensated.

Moreover, as the Company assumes most of the cost of the plans, non-highly compensated employees can afford to choose the same coverage as highly compensated employees regardless of their pay levels. In other words, our plans treat all employees alike. For instance, flexible credits for medical coverage are based on family status so employees get exactly the same number of credits whether they are senior executives or clerks. When we introduced our flexible benefit plan in 1988, all eligible employees were given sufficient credits to permit them to completely replicate the benefits they had enjoyed in the previous year prior to the flexible options becoming available. Similarly, when credits were assigned for 1989, we continued to provide sufficient credits for each employee to continue the coverage that he had enjoyed in the preceding year.

Recognizing the importance of health care, our programs require that each employee select a health care plan unless such employee can provide satisfactory evidence of coverage under a plan of another employer.

Employee participation in these plans has been very nearly what we expected. Specifically, 93% of eligible employees chose one of our plans and only 7% waived coverage by submitting proof of coverage under a spouse or parents' plan.

Looking at the statistics for the 93% of eligible employees who elected coverage under our cafeteria plan, it becomes clear that cost was not an object. 80.4% elected the high cost plans, 14.3% chose the moderate cost plan while only 5.3% elected the low cost option. Clearly our employees recognize the value of and necessity for good medical care coverage and select other coverages only after their medical needs have been met.

Hershey Foods Corporation believes strongly that tax-sheltered employee benefit plans should be nondiscriminatory. We have followed this precept in adopting our flexible benefit program in response to the differing needs of our divergent employee population. Employees can tailor their coverages to their circumstances whether they are single parents, working couples or singles. As employees' family statuses change, employees can select those benefit options that will respond to such changes.

Although HR 1864 eliminates the most complicated and costly nondiscrimination tests required under Section 89, it imposes a hardship on employees who enjoy the flexibility of cafeteria plans. This is due to the proposed treatment of cashable credits as salary reduction amounts and therefore as employee contributions even though the Company continues to pay the full cost of the plan, less a small contribution. In our case, although Hershey Foods requires a mere $3.00 contribution per month for the most expensive medical plan, the Company fails HR 1864's eligibility requirements. This is an unfortunate result of a bill whose stated goals are tax equity and expanded coverage.

It is worth emphasizing that cashable credits for benefits are offered equally to highly compensated and non-highly compensated employees alike, and the statistics show, both groups take full advantage of them. Moreover, these credits are earmarked for use in purchasing health care benefits. They are never considered part of an employee's salary, and consequently, their use for benefits purchases cannot be considered salary reduction. Although the Committee's tax experts have accepted this reasoning in the case of the highly-compensated, they have chosen to adopt the opposite interpretation in the case of the non-highly compensated. As a result, both those highly compensated and non-highly compensated employees who are covered by cafeteria plans will be forced to lose their freedom of choice and to accept more restrictive, less personally beneficial plans.

Such an outcome would cause a great deal of consternation among our employees - - all of whom have welcomed the Company's adoption of multiple benefits options which permit them to select coverages tailored to their individual needs. We urge the Committee to rethink the impact of HR 1864 on flexible benefit plans and to arrive at a legislative solution which will preserve employees' freedom to choose those benefit arrangements which can best secure their continued health and well-being.

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STATEMENT ON THE IMPACT OF SECTION 89 AND HR-1864

Henry L. Hiebert, Esq.
Topeka, Kansas

Our comments herein address the impact of Section 89, as originally enacted, as well as our analysis of the impact of HR 1864, as introduced by the Chairman of the Ways and Means Committee. We additionally comment on overall policy and practical issues inherent in the general legislative concept used to address health system related issues.

As a general observation, it appears that subsequent to enactment of Medicare/Medicaid in 1964, the percentage of the GNP consumed by the health care system has steadily increased without commensurate movement toward achievement of coverage and delivery goal objectives. Thus, in overview, it would appear that the implementation of health policy embodied in Medicare/Medicaid have resulted in the delivery system absorbing increasing amounts of the national resources without corresponding value received either in terms of increased service delivery or in terms of measurable results with respect to the general health of the nation's population.

The impact of Medicare/Medicaid policy on overall system cost cannot be minimized. A recent GAO study on the Payment System for Outpatient Cataract Surgery (GAO Testimony before the Ways and Means Committee on April 10, 1989), for example, strongly suggests that the Medicare reimbursement policy itself may be determinative of excess costs for Intra Ocular Lenses. (Reimbursement rates supported by Medicare payment ranged from $90 per lens to $450 per lens while a Canadian Hospital was able to obtain lenses from an American manufacturer for $80 per lens). While this observation may not be entirely apropos, nevertheless the point remains that the intrusion of legislative policy has tended to significantly alter system cost compared to that which would be attainable were market forces permitted to determine those costs. While current studies of the Medicare system understandably focus on cost setting problems, they appear to sidestep fundamental macro level considerations of establishing affordable national minimum standards for health status and instead seem to presume that any type or level of care that can be purchased should be within the rights of every citizen.

We submit that a present boundless goal of providing "open ended" medical care is beyond our nation's economic reach. It is not that the goal is not worthwhile, it is simply that the goal establishes an unlimited cost budget for health care. Such an open ended statement of the national health policy effectively eliminates market forces for determining overall system cost, since demand has been predetermined. For example, in a "free market" model, some medical devices may not be developed simply because the likely market recovery would not support the necessary research and development or the manufacturing costs associated with the product. On the other hand, under the present system, incentives do exist for the development of high cost devices, such as CT Scanning and Magnetic Resonance Imagery, simply because the developers know that ultimate approval for Medicare reimbursement will permit product cost recovery.

While the products resulting from research and development in the medical industry are certainly not "bad" results, the extraordinary costs of research and development itself, and also those associated with the implementation of the technologies so developed, have created enormous financial burdens on the system. Moreover, the focus on high cost technology driven medical intervention has diverted attention from other possible intervention techniques and, more importantly, has largely caused us to ignore the responsibility of the individual in achievement of reasonable levels of health status. In essence, the statement of the national health care policy appears to read something like "every citizen should be entitled to the highest possible quality of health care without regard to cost and without regard to the responsibility of the individual with respect to his or her own personal health status." This, indeed, has the ring of a reimbursement policy rather than a health policy which, it would appear, is all that we have yet to succinctly develope. If automobile manufacturers made similar warranties for their products, then those car owners who failed to change their oil would be entitled to the same level of protection as those who faithfully carried out the manufacturer's prescribed routine maintenance. Should automobile manufacturers extend such an open ended warranty, they would either end up in bankruptcy or the prices for automobiles would increase to the extent necessary to "fund" the irresponsibility of those owners who did not choose to perform routine maintenance.

While implementation of Section 89 has a likely static impact (alter current contribution, coverage and cost patterns as described in the practical considerations set forth below) it also has a likely impact on the dynamics of the health management system itself. This latter aspect deserves critical attention, since the failure to fully address the real mission of the health system and especially the long term dynamics of health care funding at the time of the inception of Medicare has led to system abuses and cost escalations which were clearly not foreseen by the drafters of that legislation.

To the extent the Medicare/Medicaid reimbursement policies constitute artificial markets and have an adverse impact on marginal cost effectiveness, shifting any portion of program costs to those not responsible for the cost and priority setting mechanisms seems unwarranted. On the other hand, if priorities can be established within the national health policy and private sector competitive processes can be infused into the health care reimbursement system, then, perhaps, reasonable levels of health status can be achieved for all members of our society.

Therefore, while broad coverage and benefit mandates can be used to assign individual health risk to identifiable risk pools both within and without the private sector, it is believed that the absence of attention to identification and limitation of the mission of the national health policy will likely cause such mandates to create disproportionate burdens on the national economy, irrespective of to which risk pool the burden is shifted.

We are therefore of the opinion that the issue of tax subsidization of health benefits should be integrated with developement of the limitations and priorities of the national health policy.

We recognize that the relative roles of the private and public sectors in achievement of the mission of the national health policy is clearly an addressable issue. On the other hand, it must be clearly understood that the assignment of large blocks of the risk to the private sector, without corresponding private sector control over reimbursement policies, essentially separates functions of responsibility and accountability. A public policy which fosters uncontrollable cost increases should not also shift the burden of paying for those increases to those who have little impact on the cost setting policy. Since there is substantial evidence that the high system cost is, in large measure, the result of excesses arising out of the Medicare/Medicaid reimbursement scheme, shifting the system cost outside of the public sector removes Congressional accountability for the excesses created by Congressional Policy. It is entirely too suggestive of a "we broke it, you pay for it" attitude, and one, which, equally unfortunately, removes the incentive for Congressional intervention to address significant policy priorities.

Because we view Section 89 as merely a risk allocation device, overall total system cost should not be materially impacted. In other words, it is assumed that any program of mandated or "tax incentive" health care is merely a more carefully prescribed method of determining from whence the direct funding of the cost of the care will come. It is also assumed that health care is currently generally available, either through publicly pooled risks (such as Medicaid), partially pooled risks (such as charitable contributions from providers who then pass on the cost to those who can pay through higher service fees to those who can pay) or unpooled sources (such as direct payment by the uncovered individual). Viewed in this light, Section 89 would appear to solely address issues of risk incidence rather than the broader issue of coverage which it purportedly addresses.

This model is not perfect, however, and the accessibility of reasonable quality of minimal health care to those presently uncovered, needs to be more fully evaluated as does the relative funding cost for this care through the public as opposed to the private sector. Another potential imperfection of the risk-shifting-only model may lie in the likely provider and facility reimbursement of charitable write-offs presently built into the cost structures. While the incidence of these charitable write-offs may be inequitable among the universe of providers and facilities, nevertheless they have been a legitimate assumption in constructing reimbursement schedules (the Hill-Burton Act mandated unrestricted access without regard to ability to pay as a condition of the receipt of federal funding). Despite our somewhat more limited exposure to widescale facility data, industry wide experience seems to indicate a rather substantial charitable write-off, some portion of which would presumably be absorbed by private funding mechanisms if a greater portion of the risk were shifted to the private sector. As these charitable write-offs constitute a portion of the current cost structure, it is reasonable to assume that broader private sector coverage mandates will result in new overall system costs to the extent that the pre-mandate write-offs will become translated into new costs to the private sector without an accompanying cost reduction among the universe of providers and facilities. In any event, the goal remains essentially the same, that being to provide a reasonable level of health care, i.e., treatment of disease, to all in need of this care, with a reasonable allocation of the costs of goal attainment shared between the public and private sectors.

While we are gravely concerned about the separation of responsiblity and accountability under mandated risk shifting models such as those found in Section 89, we have other significant concerns arising out of the "transportation" of the deficiencies of the Medicare/Medicaid model to the Section 89 private sector model. Aside from the open-ended cost issues, the lack of attention in Section 89, and particularly the proposed amendments, to the role of individuals within the health management system is particularly problematic. The HR 1864 amendment, and to a lesser extent, the 1986 enactment, both restrict the capability of shifting cost increases to employees. In the case of HR 1864, which limits employee exposure to $10 per week for single participation and $25 per week in the case of dependent participation, this may, in fact, immediately result in an increase in the employer contributions to already broad based plans. While this may be objectionable for other reasons, it is more significant in that it represents a Congressional policy statement that cost increases, which are largely beyond the control of the employer (and may, in fact be partially spawned by short-sighted Congressional Policy) should essentially be shifted predominantly to the employer. From a policy perspective, this would appear to ignore the role of the participant in the control of health care costs. Given current data about the role of the individual in controlling factors which influence the need for health care intervention, and therefore the cost of health care itself, any Congressional mandate which limits financial exposure of the individual to increases in the cost of health care seems seriously deficient. For example, should individuals whose lifestyles have a high incidence of cost to the system, be subsidized by those who have modified their lifestyles to eliminate these risks? Should smoking, with its demonstrable risks for heart disease, lung disease and cancer, receive health protection at the same premium cost as those who do not engage in this lifestyle? May incentives be given to those who engage in health improvement programs, such as weight reduction programs and drug and alcohol abuse programs? Should not the individual be taken into account as an essential leg in the health maintenance system? Does the "lid" on premium costs under either the 1986 enactment or HR 1864 provide sufficient flexibility in designing programs for the attainment and maintenance of a reasonable health status? Is Congress, in its frantic attempts to address public expenditure problems, establishing a program that significantly reduces the ability of plan sponsors to design programs which address reasonable health system objectives?

Unfortunately, it appears to us that Section 89 and HR 1864 both suffer from the serious defect of constituting "band aids" to problems generally spawned by excesses arising out of the national health care reimbursement policy enacted in Medicare and Medicaid. They both represent attempts to shift the risk of Medicare/Medicaid promoted cost escalations to others rather than deal with the problem itself. It is our opinion that Section 89 should be repealed and resurrected only when the Congress is able to address the larger cost issues of the health care system. Shifting the burden of cost escalations largely controlled by Congress to the private sector is neither logical nor sound policy. If Congress controls the system, then the public costing of the program must attach to this control. Shifting the economic burden of the problem elsewhere merely removes from the Congress accountability for its inability to effectively address the issues.

While the above represents predominantly policy considerations as seen from one who regularly consults with businesses on the issue of health care funding, other practical considerations also dictate that Section 89 be repealed.

Section 89 appears to have a differing impact dependent upon the size and characteristic of the business involved. Within the universe of all employers, the impact is likely to only reduce required employee contributions. Among large manufacturing employers, where collective bargained benefits exceed core benefit limitations, little enhancement would occur, save for any testing required by Section 89, which presumably will be passed through to the consumer through price increases. (In this sense, the broadened base of cost sharing approaches a publicly funded model.) Among large and small employers in the service sector, our experience indicates that many do not currently provide benefits at Section 89 (as enacted or under the proposed amendment) coverage levels. Thus, for these employers, the choice is typically either to enlarge the coverage base to protect the program, or to make a cost/benefit determination of the validity of maintaining a plan. In most instances in which we have been involved in preliminary review, the employer/sponsor response has been to eliminate the plan and to correspondingly adjust compensation levels for those employees previously covered under the plan. Even though cost adjustments frequently take into account tax consequences to the employees, exercise of this option was immediately cost effective over those which would occur under the Section 89 requirements and, in addition, removed from the employer the exposure to likely future Congressional amendments and predictable premium cost increases.

In our consultative capacity, our objective is generally to achieve and maintain a reasonable level of health status for the employees of those who employ us. This must be accomplished within the context of systems over which the employer has only a modest level of control. For example, an employer generally has little control over the provider or health facility, nor does it have control over Medicare "approved" costs or levels of insurance reimbursement. Furthermore, there is little contemporary evidence to suggest that the key players in the health management system have much incentive to control costs. Managers of shared risk pools generally pass through experience to new premium years, frequently at greater profit than for the prior year. It is only recently that the excessive burdens on the Medicare system have caused much concern in the government, and here the response is to find ways to shift the costs out to the private sector. As a consequence, employers must look to aspects of the system wherein they, or plan participants, have some measure of control. Thus employers can control benefit levels, even though they cannot control benefit costs. Employees, on the other hand, have an enormous amount of control over their own health, primarily through adjustments to their lifestyle. These techniques limit employer exposure to risk, on the one hand, and generally reduce health risk to the individual on the other. Note that this technique is intended to bypass the excessive costs attendant to the use of medical intervention. Participant related strategies, i.e., "wellness" strategies are increasingly important simply because public intervention has artificially distorted the economic values of illness intervention. On a macro level, for those who must compete among international competitors, this has effectively resulted in a surcharge in product cost over those produced in countries where the cost of health care represents a considerably smaller portion of the Gross National Product than it does in this country. This result would appear to be antagonistic to national policy as well, particularly when our relatively low manufacturing productivity does not compensate for our relatively low unit output labor cost, thus rendering foreign manufactured goods cost competitive at a time when our national consumption exceeds output by a considerable margin.

While suggesting revisions to Section 89 short of its outright repeal, is somewhat distasteful to us without a fuller examination of the entire health care management system, some alterations of the system may be indicated. These are outlined below.

Assumptions

1. We assume that the mission of the national health policy is the achievement and maintenance of a reasonable level of individual health status on as broad a coverage level as possible.

2. We assume that the use of tax benefits encourages private sector participation in the health management system.

3. We assume that tax policy can influence the manner and cost of delivery of health maintenance and care.

4. We assume that the national policy is to achieve the mission at a reasonable cost relative to that which is paid by those with whom we internationally compete or will compete.

Recommendations

1. Tax benefits be limited to a standardized plan containing defined coverage and benefit characteristics.

It is believed that §89 and its statutory antecedents (the prior nondiscrimination rules) are the result of Congressional misfocus on how the system is going to be funded rather than on the fundamental objective of the national health policy. The ill design of the system already has promoted a top heavy cost structure which undoubtedly will take years to bring within the range of acceptability. At this juncture it would appear more logical to focus energies on a "product" design which will meet national health policy objectives and then, to the extent possible, leave market forces with the task of regulating the costs. It should be amply clear at this point that government intervention in system pricing has been largely a failure, and one which Congress is now seeking to overcome by shifting the burden outside the public sector.

If a "product" oriented philosophy is followed, the Congress would define by statute, a product which meets fundamental policy objectives, including well defined coverage and benefit levels. That product, and that product alone, would be eligible for tax favored treatment. As a suggestion, the product must contain wellness related incentives and disincentives. For example, those who engage in high risk lifestyles (such as tobacco use) must be required to participate at a higher cost level. Those who participate in certain defined wellness programs would be similarly rewarded. Certain types of laboratory testing would be required as a condition of tax favored treatment. For example, mammographies would be mandated as would tests for colo-rectal cancer.

2. Additional benefits could be provided by auxiliary products but such auxiliary products would not receive tax subsidy, nor could they be "tied" to the issuance of the standard statutory product.

Anticipated Results

1. The elimination of tax benefits for non-core benefits will reduce public subsidization of illness intervention beyond those within the currently affordable national policy objective. This could (and perhaps should) be extended to Medicare and Medicaid reimbursable benefits as well. Since a statutorily defined product should result in the pooled risk industry designing a product to meet the statutory specifications, it is believed that the pooled risk industry will respond by focussing efforts on reducing the cost for this product in order to obtain competitive market positioning. At present, pooled risk carriers seem to have little incentive to reduce benefit costs since these are generally passed through to consumers as future premium increases, and profits, to the extent they remain a constant percentage of gross premium dollars, increase with each premium increase. In order to encourage this result, the statutory product must be a "stand alone" product, with no tie-in permitted. In other words, an insurance carrier must offer a product meeting the statutory specifications without regard to any other health related product offered by that carrier.

2. The use of allowable participant cost adjustments for participation in wellness activities promotes the accountability of the individual for those aspects of health over which the individual has control. Existing data strongly suggests that wellness has a demonstrable impact on the overall cost of illness intervention, thus the overall system cost should be correspondingly reduced.

3. The use of a focussed tax policy should promote the development of products which could conceivably have a controllable cost (through imposable ceilings on the value of the benefit available for favorable tax benefit). It is believed, for example, that the insurance industry, having a uniform product

design parameter, will design risk pools and practices which would focus attention on keeping costs within the mandated parameters.

In summary, it is believed that Section 89, in its current or proposed form, is seriously defective in that it perpetuates existing problems and merely shifts the incidence of the funding burden for a system which has demonstrated shortcomings in achieving a rational national health policy goal. It is further believed that a product oriented tax policy would encourage competition among health care insurers, plan sponsors and health care providers. To the extent that the statutory design provides incentives for individual wellness, it would promote individual health responsibility.

STATEMENT OF V. MARC DROPPERT AND BRENDAN O'FARRELL, HOWARD JOHNSON & COMPANY

SECTION 89

Section 89 of the Internal Revenue Code was intended to ensure that the tax-favored treatment of employer-provided welfare benefits is consistent with appropriate public policy objectives.

Examination of the legislative history indicates that Congress intended that the law would:

1. assure that benefits are provided to all classes of employees on a non-discriminatory basis;
2. encourage extension of coverage to presently uncovered classes of employees ;
3. require improved disclosure of information on welfare benefit programs to covered employees;
4. eliminate tax-favored treatment for plans which do discriminate in favor of highly compensated employees (i.e revenue enhancement).

While there is significant merit in the underlying objectives of Section 89, these worthwhile intentions are overwhelmed by the unduly complex testing requirements and related recordkeeping and data collection burdens the law imposes.

For the past 14 months, we have been conducting a detailed study of the impact of Section 89 in operation. Our analysis is based on data and case studies for a sample of employers with 300 to 12,000 employees. These companies represent a broad cross-section of industries, geographic locale, labor circumstances, and benefit program design.

As a result of the work we have completed thus far, we have concluded that **the requirements of Section 89 are onerous for all employers.**

Smaller employers simply do not have the internal resources to understand and respond to Section 89. The costs of internal response efforts and external professional assistance create a significant financial burden for smaller employers.

Larger employers generally do not sponsor intentionally discriminatory welfare benefits. For these companies, our studies show that the law results in significant internal and external expenses which far exceed the amount of forgone tax benefits for any "excess" benefit values provided to highly compensated employees. In all cases, the actual administrative costs of compliance exceed IRS estimates by a wide margin.

As it pertains to welfare benefit plans sponsored by larger employers, we believe that Section 89 will result in a net loss to the Treasury, rather than the net gain predicted by the Congressional Budget Office. This is true even after consideration of the additional incremental tax income the law will generate for consultants and attorneys.

Additionally, we believe that there will be widespread unintentional non-compliance, particularly by small businesses, due to lack of knowledge and/or practical inability to respond.

Further, rather than extending coverage to meet the present complex standards, many employers are likely to respond by eliminating coverages and/or adjusting work schedules.

Examples of such actions include eliminating plan alternatives such as HMOs or PPO options. Some small employers may even be moved to eliminate optional dependent coverages so that only one "employee only" coverage remains. Employers could change scheduling policies to limit available employment to either less than 17 1/2 hours or more than 35 hours per week. Except in industries such as fast food or auto service stations and parts retailers which employ many part-time student workers, work weeks of less than 20 hours are uncommon. Accordingly such employment policy changes would be relatively easy to accomplish.

We know that Congress is aware of the fact that there are fundamental problems with Section 89 and that several bills have been introduced to significantly modify it. While it is "popular" to advocate repeal instead of reform of Section 89, of the legislative alternatives, H.R. 1864 most consistently maintains the substantive objectives of Section 89 while streamlining its administrative requirements. In doing so it addresses the following major deficiencies of existing Section 89:

1. Plans which are made available to Non-Highly Compensated Employees (NCHEs) and to Highly Compensated Employees (HCEs) on a nondiscriminatory basis should not be required to comply with the current, burdensome testing requirements. H.R. 1864 significantly streamlines the testing requirements.

2. Separate testing of each plan coverage alternative creates an unfair potential for Section 89 noncompliance based on voluntary employee elections. H.R. 1864 recognizes that as long as the alternatives are available on a truly nondiscriminatory basis, actual coverage differences will not cause noncompliance.

3. Including union employees in an employer's Section 89 compliance testing is in fundamental conflict with negotiated labor-management relationships. H.R. 1864 appropriately requires that collectively bargained plans be tested separately.

4. In penalizing employees for a company's failure to comply with Section 89(k), Section 89 effectively further punishes the intended beneficiaries of its provisions. H.R. 1864 appropriately penalizes the company for noncompliance with its plan qualification requirements by imposing an excise tax on the company.

5. The 17 1/2 hour standard for part-time employees is at best confusing and at worst creates a hardship for both employers and employees, particularly in industries that historically employ significant numbers of part-time, student employees. The 25 hour standard in H.R. 1864, with proportional treatment of employees who normally work between 25 and 30 hours per week, is a more equitable approach to including part-time employees.

Although H.R. 1864 goes a long way to relieving the burdens imposed by the current statute, we believe there are certain areas of the proposed bill which should be modified and/or clarified. In our opinion, the modifications we suggest will result in a bill which more closely meets the underlying policy objectives of the original statute.

1. The treatment of "salary reductions" in paragraph (e)(3)(C) may be inappropriately broad.

   If the reference to "contribution" is intended to mean "periodic payments by employees of a portion of plan premium expense", as can be implied from the use of "contributions" in paragraph (c)(2)(B), then confirming legislative history or adding a definition of "contribution" will be helpful. If "contribution" in paragraph (e)(3)(C) is intended to refer to all salary reductions, including employees' share of premiums, deductibles, co-insurance, co-payments, and items excluded from coverage, the salary reduction plans will inadvertently be at risk.

   If the latter interpretation is intended, we would recommend that it only apply to the benefits test (under paragraph c). This approach will preserve the intended relationship between benefits made available to "Non-Highly Compensated Employees" (NHCEs) and "Highly Compensated Employees" (HCEs) without compromising the validity of salary reduction plans for all employees.

2. H. R. 1864 provides that unless the availability standard in (c)(1)(B) for core coverage offered to at least 90% of all employees is met, the full employer provided value of benefits will be treated as taxable income to all HCEs.

   We believe this standard may result in unintended and undesirable financial burdens for many employees who are considered "highly compensated" under the statutory definition but are by no means wealthy individuals.

Some medium to larger companies will simply not be financially able to meet a 90% standard. There may be no intention to discriminate but simply a workforce structure which consists of currently uncovered part-time employees exceeding 10% of a given population.

The statutory definition of HCEs is based on annual compensation in 1989 of $54,480. In some industry sectors such as high-technology, more than 20% of employees will be in this category. Many live and work in high cost areas such as California. The effect of the current language in H.R. 1864 would be to add as much as $3,000 to $5,000 per year in taxable income to such individuals who have employer-sponsored and financed dependent coverage.

An alternative which would solve this problem is a single "benefits test" under which the value of "excess benefits" is determined. Benefit value could be determined in a manner consistent with the valuation of benefits under COBRA or any other reasonable actuarial basis. Under this approach, the "excess benefits" would be determined in a manner similar to determinations under 401(k) plans. That is, the excess benefit value would be the excess of the average benefit value provided to HCEs over the average benefit value provided to all NHCEs, including those not covered.

This would properly tax the differential benefits provided without representing an excessive burden to mid-level employees. We believe it would also continue to encourage extension of coverage over time.

3. H.R. 1864 effectively mandates employer subsidy of dependent coverages in paragraph (c)(2)(B). As a matter of policy, many employers offer the availability of dependent coverage but do not subsidize it directly. Many feel that similarly situated employees should be compensated equally regardless of marital or family status.

   This problem can be solved by eliminating the words in parenthesis "$25.00 per week in the case of family coverage" and substituting a new sentence simply requiring premiums for family coverage to be the same for all eligible employees in a given plan and making it clear that the $10.00 per week amount applies to employee coverage only.

We would be pleased to discuss these comments and provide back-up data and assistance at your convenience.

Respectfully submitted,

Howard Johnson & Company

STATEMENT OF INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

This statement is submitted on behalf of the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW). The UAW represents 1.5 million active and retired workers, most of whom are covered under negotiated health benefit plans.

The UAW generally supports the framework of the legislation which has been introduced by Chairman Rostenkowski (H.R. 1864) to simplify the non-discrimination rules for employee benefit plans under Section 89 of the Internal Revenue Code. We believe that H.R. 1864 would continue to foster the underlying objective of non-discrimination in employee benefits, while at the same time greatly reducing the administrative burdens on employers under Section 89. However, there are several areas in the current draft of the bill which should be examined and improved. Specifically, we urge the Committee to:

1. Reduce the premium-sharing levels by a substantial amount and limit other medical cost-sharing in the benefit design standard;

2. Index the premium-sharing levels according to the Bureau of Labor Statistics (BLS) measure of "Average Weekly Earnings" of production and non-supervisory workers in the nation;

3. Develop separate premium and cost-sharing levels for retirees and their families;

4. Substantially reduce the 133 percent standard for the permissible range of premiums when comparing health programs for highly-compensated employees versus other workers.

5. Require employers, who are responsible for any discrimination built into the design of their health care programs, to pay any tax penalties associated with a failure to pass the Section 89 non-discrimination tests.

6. Broaden the application of Section 89 standards to cover those part-time employees working 20 or more hours per week;

7. Clarify and elaborate the Section 89 rules for current retirees and for laid-off workers now, instead of leaving their resolution to the regulatory process. Retirees and laid-off workers should be tested separately. In addition, the non-discrimination standards for retirees should recognize the diversity of benefit structures covering various retiree cohorts over time, and should also recognize the relative numbers of Medicare-eligible retirees in the employer's health programs.

The UAW has been a leader in negotiating health care benefits for rank-and-file workers. Our negotiated health benefits plans typically provide the same benefits or benefit options to all workers covered under our bargaining agreements, and to their families. However, we recognize that many employers — especially those with non-union workforces — do not offer any health insurance coverage to their workers, or else only offer benefits to a select group of highly-compensated employees.

The UAW remains firmly committed to the principle that all Americans should be entitled to health care as a basic social right. That is why we have consistently championed the establishment of a national health care program, with universal coverage, comprehensive benefits, and strict cost containment and quality assurance provisions.

One important step toward the goal of universal health insurance coverage would be to expand employer-provided health insurance coverage. Although employer-sponsored health care plans form the bedrock of our existing health care system, approximately four of every five of the 37 million people who lack health insurance coverage are working men and women, or their dependents. To address this fundamental problem, the UAW has supported legislation which would require all employers to provide at least a minimum package of health benefits to workers and their families, such as the "Employee Health Benefits Improvement Act of 1988" (H.R. 4951), which was proposed by Representative Stark in the last Congress. The approach adopted in this legislation would represent the best method of expanding health insurance coverage under employer-sponsored health care plans and it deserves broad support.

Consistent with this important goal of expanding access to health care, the UAW also supported the enactment of the Section 89 non-discrimination rules as part of the Tax Reform Act of 1986. In our judgment, these non-discrimination rules were needed to ensure that the health care benefits provided by employers are actually received by a broad cross-section of workers, not just a few highly-compensated employees. We have traditionally supported the principle that the granting of tax-favored status to employee benefits should be conditioned on the observance of non-discrimination rules. This principle has long been incorporated in the laws relating to employer-provided pension benefits. The UAW believes that the same principle should be equally applicable to employer-provided health care benefits.

However, we recognize that the existing rules under Section 89 are overly complex and potentially burdensome for some employers. Much of the complexity consists of numerous loopholes and "safe harbors" which enable various employers to avoid having to provide roughly equivalent health care benefits for all employees. That complexity also needlessly increases compliance costs because employers will hire expensive benefit consultants in order to understand, and often exploit, the labryinth of Section 89 regulations. The money spent on these consultants would be much better spent on providing real health care benefits to workers and their families.

The current Section 89 rules also have a serious flaw which could result in the painfully ironic situation whereby all of a firm's "highly compensated employees" could be exposed to tax penalties, including those employees who had no control over the behavior of the employer in setting up the discriminatory plan and who reaped none of the benefits from the discriminatory plan. The most obvious example of this legislative flaw would involve exposure of a relatively well-paid and high-overtime worker covered under a negotiated health plan to tax penalties because the employer set up a separate, discriminatory health plan for its salaried workers. That would be clearly illogical and unfair, but it is a possibility under current law. In a more general sense, the principle in Section 89 of subjecting employees to various tax penalties because of an employer's discriminatory conduct is simply unfair to all workers.

The legislation introduced by Chairman Rostenkowski (H.R. 1864) would preserve the principle of non-discrimination, but would greatly simplify the rules under Section 89. In lieu of the multitude of existing tests, H.R. 1864 would establish a simple, two-pronged test.

An employer's health benefit program would pass this test and be considered non-discriminatory if:

- health insurance coverage is available to at least 90 percent of the employer's rank-and-file employees, and the premiums which employees are required to pay under such coverage do not exceed $10 per week for individual coverage and $25 per week for family coverage; and
- the maximum amount of premiums paid by the employer on behalf of any highly-compensated employee does not exceed 133 percent of the premiums paid by the employer under the health insurance coverage which is available to 90 percent of the rank-and-file employees.

While we have several recommendations for reducing the levels of cost-sharing and narrowing the permissible range of premiums paid on behalf of highly compensated and non-highly compensated employees, the UAW finds that the general framework of the bill provides a good, workable basis for meeting the legitimate non-discrimination goals of Section 89. Specifically, the 90 percent coverage test would do much to ensure that most rank-and-file workers are eligible to participate in an employer's health benefit programs, a fundamental protection which non-unionized workers simply do not have widely available. The addition of a "plan design standard" which limits a worker's cost-sharing for individual and family medical care is a very sound idea and one of the most notable improvements over current law. The principle of comparing the value of the health care program offered to privileged employees to that offered to rank-and-file workers is preserved in the bill. These three principles — equal access, affordability and similar contributions for all employees — are central to the non-discrimination goals of Congress in establishing Section 89.

The two-pronged test set forth in H.R. 1864 has a number of important advantages over the existing non-discrimination rules. The new test is much less complicated, and hence could easily be performed "in-house" by employers, without having to resort to expensive benefit consultants. This preserves dollars for health care benefits for people, rather than simply adding administrative costs. These new standards would eliminate the need for employers to conduct complicated, costly testing procedures to make sure that rank-and-file employees are actually participating in the employer's health benefit program. There would not be any need to determine the family status of employees, or to collect affidavits on whether workers and their dependents have coverage elsewhere. The new test also allows employers to focus on the premiums paid by employers and employees for health coverage, rather than the "actuarial value" of the benefits. In general, employers would be able to look at their entire health benefit program in the aggregate, without having to separately test different benefit plans and options.

Employers which are providing health care benefits on a truly non-discriminatory basis should have no difficulty in passing the tests set forth in H.R. 1864, and they should be able to determine this easily, without resorting to undue expense and administrative burdens.

In addition to establishing a new two-pronged test for discrimination, the legislation introduced by Chairman Rostenkowski provides one possible approach to correcting the flaw in current law which could penalize certain unionized workers who were obviously not responsible for the employer's discriminatory behavior and who reaped no benefit from it. The bill corrects this flaw by providing that employees included in any "qualified bargaining unit" shall be tested separately in applying the non-discrimination rules under Section 89. The UAW believes that this is a workable approach, in light of the fact that the tax penalties for non-compliance with the non-discrimination rules -- both under existing law and under H.R. 1864 -- are levied against employees, rather than employers. As long as this remains the case, the UAW strongly opposes any effort to include unionized workers with the rest of an employer's workforce for purposes of applying the Section 89 non-discrimination tests. We believe, however, that other approaches to the general problem of setting a fair standard for the application of Section 89 tax penalties should be examined.

As a general principle, the UAW believes that employers ought to be required to pay any tax penalties for non-compliance with the non-discrimination rules, not employees. After all, it is the employer who is responsible for establishing and administering the health care program. If that program is discriminatory, the employer is the guilty party. The employees are blameless, and should not be required to pay for the employer's discriminatory conduct.

Imposing a tax penalty on the employer would be entirely consistent with the basic principle underlying Section 89 -- namely, that health care benefits should be granted tax-favored status only if they are provided on a non-discriminatory basis. If a health benefit program is discriminatory, its tax-favored status can be reduced or eliminated by imposing an excise tax on the employer for the portion of the health care payments which are discriminatory. It is not necessary to make workers pay taxes on their benefits in order to accomplish the non-discrimination goals of Section 89.

The legislation introduced by Chairman Rostenkowski recognizes this principle in connection with the penalties for failure to satisfy the "qualification" rules under Section 89. Under present law, if a plan fails the qualification rules all employees are taxed on the entire value of their health care benefits. As indicated by Chairman Rostenkowski in his floor statement, "This sanction is unfair because it penalizes employees who have no control over the failure to satisfy the rules". H.R. 1864, therefore, replaces this sanction with an excise tax on the employer.

The UAW is pleased that H.R. 1864 puts this sanction where it belongs -- on the employer. We believe that a similar approach could and should be adopted with respect to the penalty for non-compliance with the non-discrimination rules under Section 89. However, so long as the tax penalty remains on employees, we believe that collectively bargained health care plans should be tested separately. If the health benefits negotiated by a labor union for its members pass the non-discrimination tests standing on their own, it is simply unfair to penalize any union members for discriminatory conduct by the employer in connection with health benefit plans established by the employer for other workers. The mere fact that a few highly-skilled union members, working long overtime hours, may earn enough to qualify as "highly compensated employees" under the statutory definition should not expose them to tax penalties because of the employer's discriminatory conduct. Another way to resolve this problem would be to simply exclude workers covered under a negotiated health program from the definition of "highly compensated employees" in the Internal Revenue Code.

If the provisions in H.R. 1864 requiring separate testing of employees covered by collectively bargained health care plans remain in the final bill, we believe that the definition of "collective bargaining unit" should be clarified. The blanket exclusion of employees performing services in the fields of health, law, engineering, etc. sweeps too broadly. We recognize that this provision is designed to prevent the establishment of abusive, sham bargaining arrangements by professional corporations in order to circumvent Section 89. But there are also many bona fide collective bargaining agreements covering workers in the field of health, law, and other areas. We believe a more narrowly-drafted provision could prevent sham arrangements without excluding bona fide bargaining arrangements.

The UAW believes that H.R. 1864 could be clarified or improved in a number of respects:

First, we are concerned that the employee premium levels established under the 90 percent coverage test are too high. Many low-wage workers simply cannot afford to pay $10 per week for individual coverage or $25 per week for family coverage. The $1200 annual limit on premium sharing in the current draft of H.R. 1864 amounts to a wage reduction of about 58 cents per hour. This would cause substantial hardship for millions of workers, especially those earning the minimum wage. In order to ensure that rank-and-file workers can actually afford to participate in the health care plans offered by their employer, these premium levels should be lowered substantially. Cost-sharing should be limited in other ways, as well, by including reasonable levels for maximum deductibles and coinsurance, along with a cap on overall out-of-pocket expenses. These kinds of internal cost-limiting devices would do much to improve needed access to health care.

Second, the indexing mechanism for the premium-sharing levels should be improved by substituting, for the Social Security measure of U.S. average wages, an index based on "Average Weekly Earnings of Production and Non-Supervisory Workers on Private, Non-Agricutural Payrolls." This is a standard Bureau of Labor Statistics series which is regularly published. It focuses on compensation for the very group of people most likely to have benefit plans with premium sharing — the non-supervisory workers. Since the Social Security measure embraces earnings of all workers, including supervisory employees and self-employed individuals, it would be a much poorer measure of the actual "ability-to-pay" for the group of workers affected by premium sharing. The BLS standard also has advantages over some other federal statistical measures of taking into account changes in time actually worked and the share of part-time work in our overall economy. The UAW strongly opposes any effort to tie the premium-sharing levels to any index of medical inflation or underlying inflation rates. Since inflation in the health care industry has consistently outpaced increases in the general cost of living and increases in average wages, indexing the employee premium levels to medical inflation would greatly disadvantage rank-and-file workers. Over time, plans meeting the premium standards would actually become less and less affordable for low-wage workers. The use of any inflation-based standard would have similar results. Employers would be able to pass the non-discrimination tests by offering plans which were theoretically available to all employees, but which were actually affordable only for highly paid executives, not rank-and-file workers. It is very important to develop a fair indexing standard which recognizes that wages of lower-paid workers do not rise as fast as wages for affluent workers. Economy-wide averages, therefore, distort the true picture of the economic position held by lower-paid workers over time.

Third, we urge the Committee to use this same guiding principle of "ability-to-pay" in establishing the premium, deductible or coinsurance limits for retired workers and their families. Retirees simply don't have the same money incomes as workers and cannot afford heavy cost-sharing amounts. In addition, since most retirees have Medicare coverages, the total cost to the employer of health care for those retired families is smaller than it is for an active worker. Unless separate limits are developed for such retirees, the bill could have the unintended effect of shifting all of the costs of Medicare-complementary coverages to retirees, leaving the employer in a better position than before and placing unbearable burdens on retired workers.

Fourth, the UAW believes that the standard which permits premiums paid by employers for highly compensated employees to be 133 percent of the premiums paid for plans generally available to non-highly compensated workers is much too high. We urge the Committee to re-examine this standard and to reduce the permissible premium range to 120 percent.

Fifth, we urge the Committee to re-examine the penalties for failure to pass the non-discrimination tests, and to require employers, who are responsible for any discrimination built into the design of their health care programs, to pay any tax penalties associated with such failures.

Sixth, the UAW is troubled by the provisions of H.R. 1864 which would increase the threshold for covering part-time employees from 17.5 hours to 25 hours per week. This provision would exclude many part-time workers — the very workers who are most likely to be discriminated against and who need the protection afforded by Section 89. At the very least, we suggest that this 25-hour threshold should be reduced to 20 hours.

Finally, we believe it is important for the Committee to consider now the unique problems in developing a fair measure for testing for discrimination among retiree groups and among laid-off workers. Although retirees and laid-off workers could both be considered "former employees" under H.R. 1864, we believe they should be tested separately because of the significant differences between these two groups. In addition, it is unclear whether retirees and laid-off workers covered under negotiated health programs are to be tested separately. This should he clarified.

In its present form, H.R. 1864 also does not really speak to the issue of developing a reasonable benchmark for comparison of health benefit plans for non-highly compensated and highly-compensated retirees. In many instances, the scope and level of health benefits may be quite different among an employer's entire population of retirees, with benefits anchored in the plan design in effect at the time the person retired. In this way, an employer's health program for all retirees (regardless of income levels) actually is a collection of many health programs, with different benefit structures and costs. We are concerned that simply viewing the entire retiree population as one group for purposes of the non-discrimination tests would ignore this diversity in health benefits and costs and perhaps give employers a significant loophole through which to evade the Section 89 non-discrimination tests. That is, if the rules for testing permit the aggregation of cost-sharing and premium values over the whole retiree population in some sort of composite way, the unintended result may well be to disguise more-recent benefit and cost changes which could be discriminatory, standing alone, but which are hidden because of their inclusion in the values calculated for the entire retiree group. It is also important for the Committee to craft special Section 89 rules for retiree groups which acknowledge the fact that many retirees are eligible for Medicare and that there are significant cost differences between Medicare-complementary coverages and standard coverages. This should be considered in applying the non-discrimination standard under H.R. 1864 for the permissible range of premiums paid on behalf of highly compensated and non-highly compensated retirees. Thus, we urge the Committee to examine these issues carefully and to develop a non-discrimination standard for retirees which recognizes the diversity among retiree cohorts and which also recognizes the relative numbers of Medicare-eligible retirees in the employer's health programs.

The UAW believes that H.R. 1864 represents a significant improvement in Section 89. It would greatly simplify the non-discrimination tests, thereby reducing the cost and administrative burdens on employers. At the same time, it would continue the important principle of requiring employers who offer tax-favored health benefits to provide these benefits on a non-discriminatory basis to a broad cross-section of workers, not just to a select group of corporate executives.

The UAW supports the general principles underlying H.R. 1864 and urges the Committee to consider our recommendations for improving and clarifying this bill.

The UAW appreciates this opportunity to present our views on H.R. 1864. We look forward to working with the Chairman and other Members of the Ways and Means Committee as they consider this legislation.

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STATEMENT OF JEFFERSON-PILOT LIFE INSURANCE COMPANY TO THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES ON H.R. 1864

Prepared by Dean F. Chatlain, Vice-President and Tax Counsel

Jefferson-Pilot Life Insurance Company provides accident and health insurance to approximately 274,000 employees, and 127,000 families, through 2,540 employer sponsored group plans. Jefferson-Pilot Life also provides group life insurance to over 584,000 employees through 3,336 plans. On behalf of these employees and their employers, Jefferson-Pilot Life submits these comments in support of H.R. 1864's attempt to simplify the non-discrimination rules of section 89 of the Internal Revenue Code.

The current provisions of section 89 impose a substantial administrative burden on group life and group accident and health plans that were never designed or intended to discriminate in favor of the highly compensated employees. The decision in H.R. 1864 to replace the complex eligibility and coverage tests with a single eligibility test is clearly a step in the right direction. It has been very difficult to explain to an employer with a single health insurance plan that eligibility is less important than actual participation. Employers that sponsor plans that require employee contributions have been particularly concerned that they must obtain sworn statements of coverage under other plans to prove that their plans are not discriminatory.

Most of the employers who have their health insurance plans with Jefferson-Pilot Life are small to medium-sized employers. In the typical plan the employer pays all of the cost of the employee's coverage and the employee pays all, or most, of the cost of family coverage. As health insurance premiums have significantly increased over the last several years many employers have increased their subsidy of family health insurance coverage. We are concerned that the limit on employee contributions contained in H.R. 1864 will cause many of the family coverage plans to fail the definition of a qualified core health plan. We believe that the current approach of H.R. 1864 could have the unintended result of discouraging employer subsidies for coverages where the employee pays the majority of the cost.

Page 23 of the Joint Committee on Taxation Staff Description of H.R. 1864 illustrates the tax treatment of an accident and health plan that provides qualified core benefits for employee only coverage, but fails the definition for employee and family coverage. Under this example, the tax-favored coverage permitted to be received by any highly compensated employee is limited to 133 percent of the value of employee only coverage. This effectively limits the maximum employer subsidy of family coverage to one-third of the employer's contribution for employee only coverage. Considering the substantially greater cost of family coverage, we believe that this limit is unnecessarily low.

We recommend that H.R. 1864 be amended to allow a qualified core health plan to include a family coverage plan where the employee pays the majority of the cost, and the employer's contribution does not exceed a certain amount per week. If a plan can be considered non-discriminatory because the employee's contribution is less than $25.00 per week, we believe a family coverage plan with limited employer contributions should also be considered non-discriminatory. We believe that the limit on employer contributions could be expressed in a number of ways. For example, the limit could be an absolute dollar amount such as twenty dollars per week. Alternatively, the limit could be equal to the employer contribution for employee only coverage. Assume that an employer provides all of the cost of employee only coverage with a value of $18.00 per week, and that the employee contributes $30.00 per week for family coverage with a value of $40.00 per week. Since the employer is contributing only $10.00 per week towards the family coverage, it would pass either approach to an employer contribution limit.

We are aware of a large number of family coverage plans where the employer is contributing approximately $15.00 per week with total employee contributions in excess of the $25.00 per week limits. In certain higher medical cost areas the employer contributions can be closer to $20.00 per week, and still be less than one-half of the total cost of a family core health plan.

We recognize that the Committee is concerned that a single eligibility test could be abused if an employer could require such a large employee contribution that only the highly compensated employees could afford to participate. The question that the Committee needs to consider is whether the allowable employee contribution is large enough based on the cost of accident and health plans. Jefferson-Pilot Life has one core accident and health plan that is available on an equal basis to all employees. The combined value of employee only and family coverage is $54.35 per week. Although this plan satisfies the eligibility test of H.R. 1864 because employee contributions are $24.23 per week, it qualifies only because our company is willing to contribute over 55 percent of the total cost. Employers located in higher cost areas, or employers unwilling to subsidize more than half the cost of employee and family coverage, will not be able to satisfy the eligibility rules of H.R. 1864.

We do not believe that our home office plan, or the plans adopted by most of our group customers, are designed to be unaffordable to the non-highly compensated employees. However, because some employers are unwilling to subsidize most of the cost of family coverage, many of these plans will flunk the eligibility test. An examination of the design of these plans also shows that they are not designed to discriminate. Most plans have cash deductibles of $200.00 to $250.00, have 80 to 85 percent reimbursement of expenses until the employee is out-of-pocket $2,000.00, and provide 100 percent coverage for additional expenses.

The primary problem with H.R. 1864 is the simple fact that $25.00 per week is too small an amount for the maximum employee contribution for employee and family coverage. If the Committee is unwilling to increase the maximum employee contribution to a more realistic level (e.g. $35.00 to $40.00 per week) for employee and family coverage, then we urge the Committee to give serious consideration to allowing an employer to make a minimal contribution ($20.00 per week) towards family coverage.

The decision in H.R. 1864 to treat salary reduction contributions as employer provided benefits for highly compensated employees and employee contributions for non-highly compensated employees is difficult to justify. Plans that satisfy the $10.00 or $25.00 per week limit can still produce a discriminatory excess for highly compensated employees. For example, assume an employer pays all of the employee's coverage (valued at $15.00 per week), and allows employees to purchase family coverage with salary reduction dollars for $25.00 per week (also with an assumed value of $25.00 per week). Although the $25.00 per week would satisfy the first part of the eligibility test, only the $15.00 per week employer contribution for employee only coverage is considered for the 133 percent test. This means that highly compensated employees would be taxed on $20.00 of excess benefits per week ($40.00 total benefit minus 133 percent of $15.00 employer provided benefit of the non-highly compensated employees).

At the very least, the 133 percent benefit test should consider salary reduction contributions up to the $10.00 or $25.00 per week limit as employer contributions. You could continue to treat salary reductions as employee contributions for purposes of the $10.00 and $25.00 per week limits, but if the plan passes these limits, they would be treated as employer contributions for the 133 percent limit. Under the earlier example, the employer provided benefit would be both the $15.00 per week value of the employee only coverage and the $25.00 per week value of the family coverage.

We also recommend that the Committee change the approach to salary reduction dollars to allow the $10.00 and $25.00 per week contribution limits to be restated to an equivalent pre-tax amount. An employee who is contributing $25.00 per week with after-tax income could contribute $43.48 per week with salary reduction dollars based on the 28 percent Federal tax rate, 7.5% Social Security tax and a 7 percent state income tax. Even at a 15 percent Federal tax rate, 7.5 percent Social Security rate, and a 5 percent state rate, it takes $34.01 of pre-tax income to produce enough after-tax income to make $25.00 per week contribution. If the current proposal is adopted the practical effect may be the termination of premium conversion cafeteria plans (where the only benefit is the opportunity to pay premiums with pre-tax dollars). For individuals in the 15 percent Federal tax bracket this could increase the cost of their insurance coverage by 36 percent.

The current provisions of section 89 impose an excessive burden on employers who have no intent or desire to discriminate against the non-highly compensated employees. Those employers who are unwilling, or unable to pay the entire cost of the accident and health plan must prove that their plans are not discriminatory by obtaining sworn statements from employees who decline coverage. Unfortunately, the current provisions of H.R. 1864 continue to punish plans where the employee must bear part of the cost. We believe that H.R. 1864 will discourage employers from subsidizing family coverage. This can only make family coverage more expensive, and less available to non-highly compensated employees.

Jefferson-Pilot asks the Committee to consider these comments in simplifying section 89 of the Internal Revenue Code.

COMMENTS OF KLETT LIEBER
ROONEY & SCHORLING
ON HR 1864

We are at a critical point for United States tax policy. The 1980's has been a decade of steady erosion of taxpayer confidence in our tax system. In our system, based upon voluntary compliance, this continued erosion of taxpayer confidence is critical. There are no acceptable alternatives to our system based on voluntary compliance.

Section 89 of the Internal Revenue Code has been one of the latest causes of this erosion of taxpayer confidence. In fact it is a continuing source of the erosion at this time. It is therefore urgent that we deal with Section 89 immediately, and in a manner calculated to, not only, stem the tide of erosion of taxpayer confidence, but also to begin the process of restoration of confidence in our system of taxation. Chairman Rostenkowski's bill, HR 1864, represents a very significant step in the right direction. This bill must be passed as quickly as possible.

Taxpayer confidence has been particularly tested in the area of employee benefits. In this decade alone, we have seen eight major tax bills, making dramatic changes with respect to the tax treatment of employee benefits, as well as a host of other bills making minor changes. The major bills have required "technical corrections" legislation despite not being finally written until after passage.

The complexity of the changes has increased the cost of voluntary compliance significantly. The increased cost of compliance frustrates taxpayers, further eroding confidence, while at the same time reducing the tax base by the amount of the deductible compliance cost.

Section 89 is the latest example. As originally enacted, as part of the Tax Reform Act of 1986, it is admittedly unworkable. Needed technical corrections legislation became a vehicle for many different "simplification" proposals and took two years to pass. The technical corrections legislation finally passed made significant changes to §89. As amended, §89 covers 11 pages of the Internal Revenue Code.

The technical corrections included a direction to the Secretary of the Treasury to issue regulations implementing Section 89 by November 15, 1988, less than a week after enactment. Faced with a deadline of less than one week, the Treasury Department Tax Legislative Counsel working on the regulations stated "This is not the first time that we have had such a direction. If we meet the deadline, that will be a first". Despite the November 15, 1988 deadline, and repeated promises from various official and unofficial sources, that guidance and/or regulations would be issued "next week" or "next month", proposed regulations were not finally published until March 7, 1989, more than two months after the effective date of Section 89.

The proposed regulations are extremely complex and cover 154 pages. They do provide some needed guidance but fail to address issues of critical importance to many small and medium sized employers, issues such as part time employees. Any discussion of group term life insurance, one of the primary benefits covered by Section 89 is omitted. Dana Trier, a Treasury Department Tax Legislative counsel testifying at a Senate Small Business Committee hearing on April 13, 1989 said "the Treasury Department and Internal Revenue Service cannot, by regulation, go any further in simplifying §89 without enactment of legislation."

The number of initiatives to repeal or amend §89 is multiplying daily, and support for some action is also growing rapidly. Representative La Falce's bill to repeal §89 entirely is said to have the support of 300 Representatives. A similar Senate bill has at least 31 co-sponsers and the list is growing daily. Chairman Bentsen of the Senate Finance Committee is preparing his own bill to amend §89.

Can we blame taxpayers for being confused? Can we blame them for losing confidence in the system? Clearly the answer to both questions is no. We have a crisis, and we must deal with it now.

HR 1864 is a good solution, and it must be passed as soon as possible. Time is critical, every day lost brings us closer to another deadline and loses more in wasted compliance costs. §89 can not be repealed. The issue will not disappear, and when it is revisited the credibility of the system will suffer. The existing law is clearly unworkable. As an example, the solution that I have often recommended to many of my clients is to drop coverage for the non-highly compensated, pay for the highly compensated employees' coverage after tax, and increase their compensation to cover the tax. This is exactly contrary to the purpose of §89. We must unite in support of one workable solution and see that it is enacted as quickly as possible. HR 1864 is that workable solution.

First, it is imperative to recognize Section 89 for what it is, or more precisely, to admit what it is not. Section 89 is not a revenue raising tax measure, despite the optimistic revenue projections of the Joint Committee on Taxation. Chairman Rostenkowski's remarks on introduction of HR 1864 clearly indicate that the primary purpose of §89 was to achieve the social policy goal of insuring that tax favored benefits are provided to a broad cross section of employees. This is echoed in the Joint Committee on Taxation Staff Description of HR 1864 (hereinafter "Staff Description"). Section 89 creates a new class of taxable income but only if the employer does not pass the discrimination tests. It is certainly a strange tax that depends upon failure of the taxpayer to comply to raise revenue. Clearly, Section 89 is not now, and was never intended, to be a revenue raising tax measure. It is a penalty tax, for the purpose of encouraging the desired behavior to achieve the social policy goal.

In fact, Section 89 as it exists loses revenue. Senator Steve Symms has estimated compliance costs at 1 billion dollars annually. I am personally aware of a state supported educational institution that paid a quarter of a million dollars for a preliminary study in 1988. The cost to the tax base is 340 million dollars a year. In table A-2 (page 1371) of the Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986" (the "Blue Book") - titled "Estimated Budget Effects of the Provisions of the Act, Fiscal Years 1987-1991," the Joint Committee estimated the revenue from "Discrimination rules for employee benefits" as follows:

Fiscal Year ending	6/30/88	$72 million
Fiscal Year ending	6/30/89	$128 million
Fiscal Year ending	6/30/90	$140 million
Fiscal Year ending	6/30/91	$154 million

Netting the loss from deduction of compliance costs produces a net loss of $186 million in the best year. Section 89 loses more than it was projected to raise in every year!

Under present law, Section 89 can only lose revenue. Repeal will certainly lose revenue; compliance costs will still be deductible, but there will be no offsetting revenue. HR 1864 will reduce the loss in compliance costs significantly while producing some offsetting revenue. The result may not be net revenue, but it is certainly more than "revenue neutral" or "budget neutral". For example, the bill would permit employers who do not wish to broaden their coverage (meet the social policy goal) to admit that their plan is discriminatory, and include the full cost in the taxable income of the highly compensated employees. This provision reduces the revenue lost in deductible compliance costs and increases revenue by making it clear that the full cost of the benefit is taxable, not just the discriminatory portion of the cost, as has been suggested under current law.

In his introductory remarks Chairman Rostenkowski noted the concern of the chairman of the House Budget Committee, and his own fears, that the projections for this bill would show that it would lose revenue. We cannot let this vitally needed first step to restoration of taxpayer confidence be held hostage to deficit reduction, budget, or other revenue issues. Chairman Rostenkowski has recognized that there are problems with the revenue estimating process. The recent establishment of a revenue estimating advisory board to assist the staff of the Joint Committee on Taxation in "evaluating revenue estimating methodology" demonstrates this concern. There is no way of establishing the reliability of revenue (or expenses) estimates. We cannot afford to lose this battle on these unprovable economic issues. Taxpayer confidence in our system is at stake.

HR 1864 is a workable solution to the §89 problem, and it will be a significant first step in stopping the erosion of taxpayer confidence in our system. It is at least "revenue neutral" or "budget neutral". It is critical that this bill be passed quickly.

The bill's "plan design" approach is the most realistic approach to the problem. This approach will essentially put the solution in the hands of employers - they will have the ability to comply without costly analysis and testing. This approach should lead to a broadening of coverage, the desired social policy objective without additional compliance cost. However, the effective date and transition rules should be modified to permit employers to make a reasoned choice in 1989. (See the comments on transition rules and effective date below.) The plan design approach should also make monitoring compliance, and enforcement easier and less expensive.

The decision to omit group term life insurance from the non-discrimination provisions was wise. The discrimination rules for group term under §79, before the effective date of §89, accomplished the social policy goal of encouraging a broader base of coverage and also raised revenue by taxing the highly compensated employees receiving discriminatory coverage. The rules under §79 were working well. Treasury did not know how to deal with the special problems of group term life insurance in the same context with health care and therefore did not deal with it at all in the proposed regulations. Returning to the law prior to TRA 86 for group term life insurance makes sense.

The bill, in new IRC Section 89(c)(2) defines "qualified core health plan". Subsection (A) provides "(A) the employer-provided benefit under such plan primarily consists of core benefits, and ...". The term "core benefits" is not defined. It is not defined in present §89 either. The proposed regulations define core health benefits in 1.89(a)-1 Q&A #1(f)(7) as "comprehensive major medical and hospitalization benefits". The absence of a clear definition of this critical term leaves open exactly what must be provided. It would be preferable to define the minimum benefits required in the bill.

New IRC Section 89(e)(3)(C) deals with salary reduction contributions in essentially the same way as the proposed regulations i.e., in general, a salary reduction contribution is treated as employee provided for the non-highly compensated employees and employer provided for the highly-compensated employees. Preventing circumvention of the limits on amounts that may be provided for highly compensated employees is endorsed in concept, but the definition of "salary reduction" in the proposed regulations, and in the 1986 "Blue Book" would include all cafeteria plan contributions, whether elective or non-elective. This effectively means that an employer could not provide health benefits in a non-elective cafeteria plan. There is no need to include non-elective contributions under the tests as provided in the bill. The other provisions of the bill make use of a cafeteria plan (without elective salary reduction contributions) attractive to permit employees flexibility in their choice of benefits.

The provision for proportionate reduction for employees who work less than 30 hours in new §89(e)(5) is similar to present law and very desirable. The Staff Report sets out the new rules which are an improvement over the prior rules and will considerably ease the burden of small or medium sized employers with significant part-time employee populations.

The bill's recognition of the reality of collectively bargained plans as separate plans is also welcome. Employers are "between a rock and a hard place" under present law. Permitting employers flexibility in dealing with their union employees can only serve to further the act's social policy purpose. The union plans are not likely to be discriminatory and permitting them to be treated separately will require employers to deal with the non-union employees as a unit, while allowing flexibility.

The bill's modification of the definition of "highly compensated employee" to eliminate the requirement that there always be at least one highly compensated employee, will also further the policy objectives of §89 without sacrificing any significant revenue. This is another welcome change.

The one major problem that the bill does not specifically address is valuation. The Staff Report indicates that present law is retained. It is unrealistic to expect the Treasury Department to be able to develop a comprehensive table of relative values. Adoption of the present law safe-harbor rule as the permanent rule is preferable. One of the principal benefits of this bill is that it will simplify §89 and give us a measure of finality. Taxpayers will have a law and rules they can work with once and for all. This "final solution" is undermined by holding the valuation issue open until the Treasury Department develops its table, which may never happen. If Treasury can, and does develop a table there is no reason why the table can not be made a safe-harbor at that time, by regulation.

Removal of present law Section 89(k), the so called "qualification standards," from Section 89, to new Section 4980C is one of the best features of the bill. Elimination of the sanction penalizing all employees is most welcome. The qualification standards, are, and should be, essentially non-controversial. Dealing with them separately and adding an appropriate sanction is clearly an improvement. There is, however, a transition problem with the new Section 4980C. Section(f)(3) of the bill adopts the transition rule of Section 3021(c) of TAMRA. Section 3021(c)(3) of TAMRA requires that all the qualification standards except the written plan requirement be met by the beginning of the year. The proposed regulations extended the date for compliance with the notice requirement to July 1, 1989. The effect of the proposed regulations after passage of HR 1864 is questionable. This problem reflects the general problem with transition rules. The bill should contain a "good faith safe harbor" for compliance with all of the qualification standards for the year 1989, compliance by the end of the year should be deemed compliance for the year.

There is a problem in present law that should be addressed in the new bill. §89(j)(8) provides a one year transition period in the case of certain acquisitions and dispositions. This section does not apply to the §89 qualification standards. There is no reason to not extend the transition period to the qualification standards as well. Voluntary compliance will be encouraged by permitting an acquiring employer to correct defective plans within a transition period, rather than penalizing an acquiring employer because of a plan maintained by the employer that was acquired. Without the transition period the qualification standards have a direct effect on corporate transactions, which is unintended. HR 1864 carries over the prior law problem because new §89(e)(10) basically retains the §89(j)(8) transition rule. The separate new §4980C for the qualification standards does not include a similar provision. §4980C should be amended to include a transition rule for certain transactions similar to new §89(e)(10).

Subsection(f)(4) of the bill mandates regulations within six months of enactment. Again, this is a welcome change from prior practice of fixing specific dates that turn out to have no chance of being met. There is a question whether six months is reasonable. Also, six months from enactment is likely to be after January 1, 1990.

The effective date and transition rules are the most significant cause for concern in the bill. Delay of the effective date until January 1, 1990 does not send the wrong message to taxpayers. On the contrary, it is essential that an otherwise good bill, which is a significant step toward restoring taxpayer confidence, not provide an unrealistic effective date. Changing the rules "in midstream" once again will critically undermine the potential of this bill to begin the process of restoration of taxpayer confidence. Delay of the effective date until January 1, 1990 is urged. It is not likely that the bill can be passed by July 1, 1989 which is a significant date under present law. Failure to make it clear now that the effective date will be January 1, 1990 will cost more in wasted compliance costs.

If a January 1, 1990 effective date is not possible, the bill should at the very least provide for a "good-faith" compliance safe harbor for 1989. The election to be treated under present law should be eliminated because it is cumbersome and will require taxpayer action. The safe-harbor should provide that meeting the tests in §89 as in effect December 31, 1988 would be deemed compliance for 1989, and the amendment of §89 should be effective January 1, 1989.

The above specific comments with respect to HR 1864, where critical, are intended as constructive criticism and in no way should be construed as detracting from support for the bill in general. Amendments to the bill to reflect any of the suggestions would strengthen the bill, but the bill should be passed whether or not these specific comments are addressed.

May 1, 1989

Respectfully Submitted,

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SECTION OF TAXATION
LOS ANGELES COUNTY BAR ASSOCIATION

COMMENTS ON SECTION 89 AND HR 1864

The following comments represent the view of the members of the Taxation Section of the Los Angeles County Bar Association as determined by its Officers and Executive Committee.

These comments were principally prepared by the officers of the Employee Benefits Committee of the Section comprised of Robert K. Johnson, Chair of the Committee; David E. Gordon, Past Chair of the Committee and Vice Chair of the Section; Mark J. Grushkin, Vice Chair of the Committee; Steven L. Guise, Secretary of the Committee; and Roland G. Simpson, Chair of the Legislation/Regulations/Government Liaison Subcommittee of the Employee Benefits Committee.

Dated: May 1, 1989

EDWIN G. SCHUCK
Chair, Section of Taxation

Robert K Johnson
ROBERT K. JOHNSON
Chair, Employee Benefits Committee

1. General Description of HR 1864

HR 1864 would replace the current Section 89 nondiscrimination rules for health plans with a single simplified test. In general, an employer's health plan would pass the bill's test if the plan is not discriminatory on its face and:

(A) at least one plan or a group of plans providing primarily core health coverage is available to at least 90 percent of the employer's nonhighly compensated employees at an employee cost of no more than $10.00 per week in the case of individual coverage, or $25.00 per week in the case of family coverage, and

(B) the maximum amount of employer-paid premium that may be excluded from the income of any highly compensated employee is not more than 133 percent of the employer-paid premium made available to 90 percent of the nonhighly compensated employees.

The first part of the test is referred to as the eligibility test, and the second part is referred to as the benefits test.

2. Eligibility Test

If the employer fails to meet the eligibility test, then the value of all health coverage provided to highly compensated employees is includible in the taxable income of the highly compensated employees.

The limit on employee cost is intended to ensure that coverage is, in fact, available to employees. Without some limitation, there is a concern that an expensive plan could meet the eligibility requirements and yet fail to expand the availability of coverage because of the unrealistic financial burden electing such coverage would place on nonhighly compensated employees.

Policy Comments on Eligibility Test

(A) Dollar Limits on Employee Cost

We believe the proposed maximum employee costs of $10 per week for individual coverage and $25 per week for family coverage are too low for many employers and represent a serious defect in HR 1864. For example, the cost to the employer of a single-employee basic core health insurance indemnity contract in Southern California averages about $45 per week, and the cost to the employer of an employee and family basic core health insurance indemnity contract in Southern California averages about $120 per week. The proposed limits on employee costs will make it impossible for many employers, which currently offer the same health plans to all employees, to satisfy the eligibility test, or will force these employers to redesign their plans.

An important shared objective of Congress and private employers is to control escalating medical costs. The present limits on employee costs in HR 1864 will interfere with this objective. One factor causing escalating medical costs is the ability of two-income families to "double-dip"(i.e., maintain duplicative coverage) under each spouse's health insurance coverage. Setting the maximum required employee contribution too low will not help to control this problem.

A solution would be to replace the maximum dollar limits on employee costs with maximum percentage limits. The percentage limits would measure the required employee costs as a percent of the total combined costs for the employer and employee. The maximum percentage allowed for employee costs should be substantially greater for family coverage than for employee only coverage. Otherwise, employers may determine to cut back or simply not to offer family coverage paid for by the employer. We recommend limits on employee costs of 25 percent of combined employer-employee costs for employee only coverage and 50 percent of combined employer-employee costs for family coverage.

Maximum percentage limits (rather than dollar limits) will better account for differences in medical costs in different geographic areas. They will, also, avoid the necessity for indexing the dollar limits and will make the eligibility test more workable for former employees. These issues are discussed below. A less desirable alternative solution, which will not solve as many problems as percentage limits, would be to increase the maximum dollar limits, particularly for family coverage.

In addition, the bill should provide an alternative test similar to existing Section 410(b)(1). The limits on employee costs are intended to ensure that coverage is, in fact, available to nonhighly compensated employees. The alternative test is proposed to give a choice to employers who have plans which do not meet the maximum limits. Under this alternative test such employers would not have to redesign their plans where they can demonstrate that a plan, in fact, covers a substantial percentage of nonhighly compensated employees. In applying the alternative test an employer should be permitted to elect to disregard any employee and/or his spouse and dependents (if any) who are covered by a health plan providing core benefits maintained by another employer. This would be analogous to current Section 89(g)(2)(A).

Recommended Statutory Language: Proposed Section 89(c)(2)

"(2) QUALIFIED CORE HEALTH PLAN.--For purposes of this section, the term 'qualified core health plan' means any health plan if--

(A) the employer-provided benefit under such plan primarily consists of core benefits, and

(B) such health plan either (i) does not require contributions by the employee in excess of 25 percent of the total contributions by the employer and employee ~~$10.00 per week~~ (50 percent of the total contributions by the employer and employee ~~$25.00 per week~~ in the case of family coverage) or (ii) benefits (a) at least 70 percent of employees who are not highly compensated employees or (b) a percentage of employees who are not highly compensated employees which is at least 70 percent of the percentage of highly compensated employees benefiting under the plan." (New language is underlined, and language to be deleted is crossed out.)

(B) Indexing

In HR 1864 the specified dollar amounts are indexed for wage growth based on the SSA Average Wage Index. However, medical costs historically have risen far more rapidly than wages. The cost of living adjustment should be based on some index of medical costs rather than wage growth, if maximum dollar limits on employee costs are retained. Otherwise the maximum dollar amounts will very soon be out of date.

(C) Leased Employees

A major difficulty will remain in applying the eligibility test in the case of leased employees. The data-gathering and administrative burden posed for large employers is unnecessary and disproportionate to any likely benefits.

We discuss the problem and our recommended solution below under the headings "Special Rules: (E) Leased Employees."

Technical Comment on Eligibility Test

"Core health plan" is not defined in HR 1864. It may be appropriate to define this term.

3. Benefits Test

The purpose of the benefits test contained in HR 1864 is to ensure that highly compensated employees do not receive a disproportionately higher level of employer premium than the level of employer premium that is available to the nonhighly compensated employees. Under HR 1864, the maximum tax-favored-benefit that a highly compensated employee may receive is generally 133 percent of the smallest employer premium for the employee-only coverage that is taken into account in applying the 90 percent test. However, if a highly compensated employee elects family coverage, and if the employer maintains a plan that provides family coverage that meets the requirements under the bill for the 90 percent test, then the maximum tax-favored premium is increased to 133 percent of the smallest employer-paid family premium taken into account in applying the 90 percent test. Any employer-paid premium received by a highly compensated employee in excess of the level of employer-premium that meets the benefits requirement is includible in the taxable income of such employee.

Policy and Technical Comments on Benefits Test

We generally support the benefits test in HR 1864. However, as presently drafted, it contains potentially fatal defects.

First, the benefits test will not work for cafeteria plans when it is applied using the proposed special rule for salary reduction contributions. The result will be to kill cafeteria plans and flexible spending accounts through the back door of Section 89.

We think the problem in this regard is not with the benefits test, but rather is with the special rule for salary reduction contributions. We discuss the problem and our recommended solution below under the headings: "Special Rules: (A) Salary Reduction."

Another serious defect relates to the measurement of the taxable benefit. Proposed Section 89(b)(2)(A) provides as follows:

"(2) TAXABLE BENEFIT UNDER PLANS MEETING ELIGIBILITY REQUIREMENTS.--

(A) IN GENERAL.--The taxable benefit of any highly compensated employee under health plans meeting the requirements of subsection (c) is the excess (if any) of--

(i) such employee's aggregate employer-provided benefit under such plan, over

(ii) 133 percent of the amount which would have been such employee's employer-provided benefit if he had been a participant with the same status in the plan which was taken into account in determining whether the requirements of subsection (c)(1)(B) are met and which would result in the smallest employer-provided benefit determined for purposes of this clause."

The Floor Statement of Chairman Rostenkowski includes the following example:

"Example 3.--An employer maintains several health plans. Three plans are core health plans. Each core plan is available to over 90 percent of the nonhighly compensated employees. The employer cost of each of the three core plans is $500, $1,000 and $1,500 respectively. The maximum excludable benefit that may be received by any nonhighly compensated employee is $1,995 ($1,500 x 1.33). Thus, any highly compensated employee would have taxable income to the extent that the employee receives over $1,995 in health coverage."

It is unclear from this Example how the benefits test operates under the bill. If the smallest employer-provided benefit is used, why isn't $500 (instead of $1,500) used to measure the taxable benefit in the example? Is it relevant in the example that each core plan is available to over 90 percent of the nonhighly compensated employees?

Hypothetical Example: Assume an employer has two plants in different geographic locations, and 50 percent of its employees work at each location. Assume further that the employer offers core plan A with an employer cost of $500 to all employees at location A and core plan B with an employer cost of $1,000 to all employees at location B. Finally, assume that a disproportionate~~ly~~ larger percent of highly compensated employees work at location A.

Under this hypothetical example, will the highly compensated employees at location B, who receive an employer provided benefit of $1,000 have $200 of taxable income ($1,000 less $800 [1.33 x $600])? Does this result occur because neither plan, by itself, covers 90 percent of the employees?

This would be an absurd result, and surely cannot be intended. In the example each plan is available to all employees at its geographic location on a completely non-discriminatory basis. Accordingly, the highly compensated employees should have no taxable income.

We believe this potentially fatal defect in HR 1864 can be corrected with some minor changes.

Recommended Statutory Language: Proposed Section 89(2)(2)(A)

"(2) TAXABLE BENEFIT UNDER PLANS MEETING ELIGIBILITY REQUIREMENTS.--

(A) IN GENERAL.--The taxable benefit of any highly compensated employee under health plans meeting the requirements of subsection (c) is the excess (if any) of--

(i) the sum of such employee's aggregate employer-provided benefit under such each plan~~s~~, over

(ii) 133 percent of the sum of the amounts which would have been such employee's employer-provided benefit under each such plan in which he participated if he had been a participant with the same status in the plan which was taken into account in determining whether the requirements of subsection (c)(1)(B) are met and which would result in the smallest employer-provided benefit determined for purposes of this clause for each such plan." (New language is underlined, and language to be deleted is crossed out.)

An additional technical problem exists in applying the benefits test. Proposed Section 89(b)(2)(C) allows an employer to elect to aggregate two or more qualified core health plans and treat them as one plan if each of such plans is available to the same group of employees with the same eligibility requirements.

First, it is not clear whether there must be a 100 percent overlap in the eligible group of employees and in all of the eligibility requirements. For example, if an employer offers an indemnity plan and an HMO, can these plans be aggregated if they have minor differences in employees who are excluded or in waiting periods to commence participation?

A "plan" is not defined in HR 1864. It may be necessary to define this term in order to apply proposed Section 89(b)(2)(C) relating to aggregation of "plans."

4. Excluded Employees

(A) Technical Comments

Proposed Section 89(d)(1) would exclude from consideration certain categories of employees, such as employees who have not completed six months of service or who normally work less than 25 hours per week. However, under proposed Section 89(d)(2) these exclusions would not apply unless no employee within the excluded category was eligible to participate in the plan. Further, under proposed Section 89(d)(3) an exclusion for most categories of excluded employees under Section 89(d)(1) will only be available if the exclusion applies to all health plans of the employer.

As presently drafted, proposed Sections 89(d)(2) and 89(d)(3) will be counterproductive. They will make it difficult for an employer to offer coverage to some employees, including nonhighly compensated employees, within a particular category without offering coverage to all employees within that category. For example, an employer would be required to have the same waiting periods and age limitations for all of its plans. Where this is not presently the case, it will encourage an employer to cut back coverage under all of its plans to the lowest common denominator.

A better solution would be to tax any highly compensated employee who has coverage within any excluded category on the full amount of such employee's employer-provided benefit. To accomplish this, Section 89(d)(2) would be revised, and Section 89(d)(3) would be deleted.

Recommended Statutory Language: Proposed Section 89(d)(2)

"(2) Certain Exclusions Not To Apply If Excluded Employees Covered. -- Except to the extent provided in regulations, employees shall not be excluded from consideration under any subparagraph of paragraph (1) (other than subparagraph (E)) unless either (A) no employee described in such subparagraph (determined with regard to the last sentence of paragraph (1)) is eligible under the plan or (B) all highly compensated employees described in such subparagraph who are covered under the plan are treated by the employer as receiving a taxable benefit in the amount of the employee's employer-provided benefit under such plan." (New language is underlined.)

Section 89(d)(3) would be deleted.

(B) Part-Time Employees

Under HR 1864, employees who normally work less than 25 hours per week are disregarded for purposes of the nondiscrimination tests (compared with 17.5 hours under present law). In addition, the employee premium and the employer-provided coverage are proportionately adjusted for less than full-time employees.

Policy Comment

We agree with this exclusion of part-time employees, but think the test should be 30 (rather than 25) hours per week.

(C) Students

Proposed Section 89(d)(1)(F) provides an exclusion for students who are employees of a school, college or university where they are enrolled and regularly attending classes, if core health coverage is made available to such students by their employer.

Policy Comment

We are concerned that the requirement of core health coverage under this provision may make it more difficult for students to obtain employment at schools, colleges and universities. For example, faculty members may be deterred from hiring students as research assistants. We recommend excluding students from being considered as employees of schools, colleges and universities without any requirement that core health coverage be made available to such students.

Technical Comment

If the exclusion for students will retain the requirement that core health coverage be made available to such students, two issues need to be clarified further. First, must the core health coverage for students be the same as for other employees? Second, may the core health coverage be made available at full cost to students, or only within the limits on employee costs contained in proposed Section 89(c)(2)(B)?

A drafting error also needs to be corrected. As presently written, the exclusion for students requires that core health coverage be made available to students. However, under Section 89(d)(2) the exclusion for students would only be available under a plan if no student was available for coverage under the plan. This drafting error could be corrected by revising the language in Section 89(d)(2) which presently reads "(other than under subparagraph (E))" to read "(other than under subparagraph (E) or (F))."

5. Special Rules

(A) Salary Reduction

We are concerned about the potential impact of Section 89 on cafeteria plans and flexible spending accounts. These plans, which are subject to strict regulations under the Internal Revenue Code, are extremely desirable in allowing employees maximum flexibility to select among fringe benefits offered by their employers. For example, many plans allow employees to select among health plans which offer different levels or types of coverage.

HR 1864 will have an extremely adverse impact on these plans due to its "Heads I Win, Tails You Lose" treatment of salary reduction contributions. Under the bill, amounts paid through salary reduction are treated as an employee contribution for nonhighly compensated employees, because salary reduction represents a cost to the employee. However, for purposes of determining the employer premium received by highly compensated employees under the benefits test, the bill treats salary reductions as employer contributions.

Unless Congress wants to kill cafeteria plans and flexible spending accounts for all employees through the back door of Section 89, it is essential to treat salary reductions in a consistent manner for nonhighly compensated and highly compensated employees. Presumably, salary reductions should be treated as employee costs in both cases. If salary reductions were treated as employer contributions in both cases, it would undermine the maximum limits on employee costs under the eligibility test.

We do not understand the suggestion in the Floor Statement of Chairman Rostenkowski that if all salary reductions are considered as employee contributions to a plan, the employer could evade the benefits test by providing all or a substantial amount of health coverage to highly compensated employees through salary reduction. Section 125 of the Code currently provides adequate safeguards against excessive benefits for highly compensated employees under cafeteria plans. Section 125(b)(1) prohibits discrimination as to eligibility to participate, and Section 125(b)(2) provides a concentration test under which a plan will fail to qualify if the qualified benefits provided to key employees under the plan exceed 25 percent of the aggregate of such benefits provided for all employees under the plan.

Recommended Statutory Language: Proposed Section 89(e)(3)(C)

"(C) Salary Reduction. -- Any contribution by reason of a salary reduction arrangement --

(i) shall be treated as an employee contribution for purposes of determining a highly compensated employee's employer-provided benefit, and

(ii) shall be treated as an employee contribution for purposes of subsections (b)(2)(A)(ii) and (c)." (New language is underlined.)

We recommend that Section 125(b)(2) be amended to apply to highly compensated employees, rather than key employees. A conforming amendment to Section 125(b)(3) is also required.

Recommended Statutory Language: Proposed Amendment to Section 125(b)(2) and (3)

"(2) HIGHLY COMPENSATED EMPLOYEES ~~KEY EMPLOYEES~~--In the case of a highly compensated ~~Key~~ employee within the meaning of section 414(q) ~~416(i)(1)~~, subsection (a) shall not apply to any plan year if the qualified benefits provided to highly compensated ~~Key~~ employees under the plan exceed 25 percent of the aggregate of such benefits provided for all employees under the plan. For purposes of the preceding sentence, qualified benefits shall not include benefits which (without regard to this paragraph) are includible in gross income.

(3) EXCLUDABLE EMPLOYEES--For purposes of this subsection, there may be excluded from consideration employees who may be excluded from consideration under section 89(d)~~(4)~~." (New language is underlined, and language to be deleted is crossed out.)

(B) Multiemployer Plans

Proposed Section 89(e)(3)(D)(ii) contains an adjustment provision to the special rule for multiemployer plans. It is unclear how this provision is intended to operate. Proposed Section 89(e)(3)(D)(iii) contains an exception for professionals to the special rule. We strongly oppose this special exception for the reasons discussed below under "Union Employees" and do not believe there is any justification for it. We expect most multiemployer plans to oppose HR 1864 unless this special exception is eliminated.

(C) Union Employees

HR 1864 provides that plans maintained pursuant to collective bargaining agreements are tested separately with respect to employees in each collective bargaining unit. We assume that proposed Section 89(e)(8) will operate in a manner similar to Section 410(b)(3), which applies to pension plans.

Policy Comments

We agree that union employees should be tested separately under Section 89.

However, under HR 1864 the separate testing for union employees would not apply if more than a de minimis number of employees in the collective bargaining unit perform services in the field of health, law, engineering, architecture, accounting, actuarial science, financial services, or consulting or in such other fields as the Secretary may prescribe. We do not believe there is any justification for this exception and strongly oppose it.

There is no evidence of abuse relating to health plans under collective bargaining agreements. Therefore, there is no reason for Congress to treat collective bargaining for health plans differently from pension plans, which are governed by Section 410(b)(3) and have no carve-out for categories of professional employees.

It is common for more than a de minimis number of professional employees to participate in plans established pursuant to collective bargaining agreements, especially multiemployer plans. Often employees of the labor unions and trust funds are participants in such plans. A number of such employees are professionals, such as attorneys, accountants, actuaries, financial officers and the like. There is no worthwhile policy reason for requiring plans to exclude these individuals from participating in plans (which is a likely result of the proposed exception for professional employees) in order to avoid counting all collective bargaining employees in applying the eligibility tests.

In sum, there is no reason for treating plans established pursuant to collective bargaining agreements differently simply because professionals participate in the plans on exactly the same basis as rank and file employees. The plans which presently cover such employees do not have the abuses of coverage which Section 89 is intended to correct.

As far as we know, the special carve-out for categories of professional employees is new and would be introduced here for the first time. It will interfere very seriously with collective bargaining in the enumerated fields. Many large employers, such as hospitals, will be adversely affected. This proposed new twist is ill-considered, hasty and an unwarranted intrusion by Congress into the collective bargaining arena. Such a provision might make sense, for example, if it applied only where a very large percent (such as 80 percent) of the employees in a collective bargaining unit were highly compensated employees.

There may, also, be jurisdictional issues. The Labor Committees of the House and Senate may need to be consulted before such a major change is made in the treatment of plans established pursuant to collective bargaining agreements.

Technical Comment

Some clarification is needed to indicate how the section would be applied separately to union employees in each collective bargaining unit. We assume proposed Section 89(e)(8) will operate in a manner similar to Section 410(b)(3), which applies to pension plans.

(D) Former Employees

As under present law, the nondiscrimination tests are applied separately to former employees of the employer.

Technical Comments

We agree that the nondiscrimination tests should apply separately to former employees. However, as presently drafted, the bill will discourage employers from offering coverage to any former employees, since it will presumably be necessary to offer coverage to 90 percent of all former employees to satisfy the eligibility test. The bill should be revised to permit coverage to be offered on a non-discriminatory basis to reasonable categories of former employees, such as retirees (rather than all terminated employees) or retirees who retired between or after certain dates. This matter should be clarified in the statute, rather than simply in the legislative history. See General Explanation of the Tax Reform Act of 1986, p. 809.

Also, if dollar limits (rather than percentage limits) are retained on employee costs, these dollar limits should be dropped or increased substantially for former employees, due to the far greater costs of medical care for older and retired persons. In particular, medical costs will be greater for former employees who retire early before they are eligible for Medicare benefits.

Recommended Statutory Language: Proposed Section 89(e)(9)

"(9) Treatment Of Former Employees. -- Except to the extent provided in regulations, this section shall be applied separately to former employees (or any reasonable class of former employees which does not (by its terms or otherwise) discriminate in favor of former highly compensated employees) under requirements similar to the requirements that apply to employees, except that no dollar limits on employee costs shall apply." (New language is underlined.)

(E) Leased Employees

HR 1864 creates a safe-harbor that allows an employer to disregard leased employees if certain requirements are met. The proposed rule is similar to the leased employee rules applicable to qualified pension plans. Under the bill, an employer may disregard a leased employee if the leasing company certifies that such employee has available a core health plan meeting the limit on mandatory employee contributions of the eligibility test. This rule, like the rule in the pension plan area, is only available if leased employees do not constitute more than 20 percent of the employer's nonhighly compensated workforce.

Policy Comment

A very major difficulty with existing Section 89 is the data-gathering and administrative burden posed with respect to leased employees, particularly for large employers. A corporation's Human Resources Department normally maintains data on employees. However, it frequently lacks information on leased employees which are paid for by the Purchasing Department.

Under Section 410(b)(1)(A) a pension plan can qualify if it benefits at least 70 percent of the nonhighly compensated employees. Accordingly, employers do not need to obtain data on leased employees unless leased employees may approach 30 percent of the employees. Under proposed Section 89 an employer will need to be concerned if leased employees may approach 10 percent of the employees. Given the difficulties in enacting Section 89 and the absence of any perceived abuse, there is no reason to make compliance with respect to leased employees more difficult for health plans than pension plans. We recommend a modification of the eligibility test, which would apply only to leased employees, to make it more analogous to the participation test for pension plans.

Recommended Statutory Language: Proposed Section 89(c)(1)(B)

"(B) the employer maintains 1 or more qualified core health plans and at least 90 percent of all employees (excluding leased employees) and 70 percent of all employees (including leased employees) who are not highly compensated employees are eligible to participate in any of such plans." (New language is underlined.)

6. Failure to Comply with Qualification Rules

An employer's fringe benefit plans are required to meet certain minimum standards, for example, that the plan be in writing, that employees be notified of plan provisions, and that the plan be maintained for the exclusive benefit of employees. Under present law, if an employer's plan does not satisfy these requirements, then all employees must include in income the value of benefits (e.g., reimbursements for health care) received under the plan. HR 1864 replaces the present sanction with an excise tax on the employer. The amount of the excise tax would be 34 percent of the amounts paid or incurred during any taxable year under any plan which fails to meet the qualification rules.

Policy Comment

The qualification rules are similar to the requirements for a summary plan description for qualified pension plans. The penalties should be the same as for a failure to provide a summary plan description for pension plans.

The amount of the excise tax proposed in HR 1864 is far too high. For a large employer, it could be an extremely large amount of money for a minor and even technical violation. If it is determined to impose an excise tax of the type presently contemplated in HR 1864, the amount should be much smaller, perhaps 5% or a specified dollar amount.

7. Group Term Life Insurance

Under present law, group term life insurance plans are subject to the Section 89 rules. To further simplify Section 89, HR 1864 generally provides that the nondiscrimination rules in effect prior to the Tax Reform Act apply to group term life insurance.

Policy Comment

We endorse this provision.

8. Effective Date

We recommend a one year delay in the effective date of Section 89 in order to allow employers sufficient time to comply with the new requirements and provisions of HR 1864.

COUNTY OF LOS ANGELES
CHIEF ADMINISTRATIVE OFFICE
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May 10, 1989

The Honorable Robert J. Leonard
Chief Counsel, Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

COMMENTS ON H.R. 1864 (ROSTENKOWSKI), RELATING TO SECTION 89 INTERNAL REVENUE CODE

On behalf of the County of Los Angeles, I offer the enclosed written comments recommending repeal or amendment of Section 89 of the Internal Revenue Code. I request that you include these comments in the record of the May 2, 1989 hearings conducted by the House Ways and Means Committee, and I urge your consideration and positive action on our recommendations.

We are aware of and agree with the national policy goal of making available employee benefits to non-highly compensated employees in a non-discriminatory manner. Consistent with this goal, the County makes available a broad, uniform benefits package to its employees, just as do virtually all other state and local governments.

While we believe and appreciate that Congressman Rostenkowski's bill is intended as a substantial improvement over the current requirements of Section 89, we are seriously concerned about the impact of a number of its provisions. Further, we continue to have concerns about the inclusion of state and local governments under the requirements of the bill when a federal agency has shown that the vast majority of local governments already provide medical coverage to virtually all of their employees.

We urge your consideration of either repeal, exemption of state and local governments, or, minimally, additional amendments to lessen the regulatory burden on agencies which are already meeting the spirit and intent of the law.

I will be happy to answer any questions you may have relative to our comments on H.R. 1864. We look forward to a continuing dialogue on this significant issue.

Sincerely,

RICHARD B. DIXON
Chief Administrative Officer

RBD:DRD
BC:le

Enclosure

Testimony Presented by
Richard B. Dixon
Chief Administrative Officer
County of Los Angeles
Board of Supervisors
713 Hall of Administration
Los Angeles, CA 90012
(213) 974-1101

The Chief Administrative Officer of the County of Los Angeles, Richard B. Dixon, on behalf of the County's Board of Supervisors, wishes to present to the House Ways and Means Committee his comments on H.R. 1864 (Rostenkowski), relating to Section 89 of the Internal Revenue Code.

The County agrees that ensuring that employee benefits are made available to rank and file employees in a non-discriminatory manner is a desirable national policy goal. Consistent with the intent of this policy, the County, similar to virtually all other state and local governments, makes a uniform package of benefits available to its employees.

We appreciate that Congressman Rostenkowski's bill is intended as an improvement over the unduly burdensome requirements of current Treasury implementing regulations. There remain certain requirements of the bill which, however, we believe should be further modified to minimize the impact on local governments, whose continually diminishing resources are already dedicated to basic taxpayer-supported initiatives.

State and local governments have been shown by the federal Bureau of Labor Statistics to be by and large equitable providers of medical and life insurance to their employees. In addition, county governments have an obligation to pay the considerable costs of uncompensated health care, in some cases for those workers presently uncovered by health insurance.

We will appreciate the Committee's strong consideration of the following recommendations for further amendment to the current Section 89 requirements:

1. Repeal Section 89 and replace it with a more straightforward strategy consistent with the goal of the Congress to expand health coverage.

2. Exempt state and local governments from the requirements of Section 89. As mentioned above, it has been demonstrated that the vast majority of state and local governments currently offer broad, equitable coverage to their employees, thereby already meeting the spirit and intent of the law. Further, it is not realistic to assume that state and local taxpayers ever have or would tolerate a wide disparity in pay or benefits among government employees.

3. Further amend current Section 89 requirements to do the following:

    a. Delay the implementation of Section 89 requirements for one year (to January 1, 1991) so as to allow employers time to await final legislative resolution of significant Section 89 issues and, where necessary, to adjust employee benefit coverage to conform to enacted legislation.

b. Specify, with regard to excluded employees, that employees who normally work less than 12 months are able to be excluded from testing requirements. This would aid jurisdictions, particularly counties whose resources are limited, in the provision of basic local government services to the public such as park maintenance, election operations, and tax collection.

c. Specify that salary reduction amounts, which under the current proposal would have to be considered toward only a highly compensated individual's health plan contribution, be included for both the highly compensated and non-highly compensated employee health plan contributions for the benefits test computation. This would result in a more equitable reflection of health insurance costs.

d. Exclude overtime earnings mandated by law in determining whether an employee is "highly compensated." This recognizes that in some organizations there may be a heavy concentration of rank-and-file employees included by definition as highly compensated merely because there is exceptional workload at some point in time and the employer must pay overtime per federal statutes and regulations.

While we appreciate the many changes H.R. 1864 makes to the current Section 89 provisions, we believe that local governments ought not to be included under its requirements because we have already been shown in the vast majority of cases to be providing equitable health benefits. We, however, have offered the above changes in an attempt to correct what we believe to be inequities in the bill's recommended amendments.

I want to thank you for the opportunity to present our comments to the Committee. I will be happy to answer any questions you may have on our remarks.

House Ways and Means Committee
on H.R. 1864
To Simplify Section 89 Antidiscrimination Rules
Applicable to Certain Employee Benefit Plans

Testimony Submitted by
Hilda E. Ford
Secretary, Department of Personnel
State of Maryland

Mr. Chairman and members of the Committee, I am Hilda E. Ford, Secretary of Personnel, State of Maryland, and I am here today to represent the State of Maryland as a public employer. I am responding to H.R. 1864, proposed by this Committee to simplify Section 89 anti-discrimination rules applicable to certain employee benefit plans.

First, I would like to say that Maryland as an employer joins the thousands of other public and private sector employers in recognizing the need for an, indeed, is petitioning for a simplification of Section 89 and the proposed regulations. In this regard, we applaud Chairman Rostenkowski for his response to our concerns. We support H.R. 1864 as an important first step toward simplification. While the intent to prevent highly compensated employees from reaping greater tax benefits than their less highly paid counterparts is laudable, the complexities of Section 89 law and regulations and the paperwork required to document compliance is a burden few employers can shoulder.

Our first recommendation with regard to Section 89 is that State and local governments be exempted from the law's eligibility and testing requirements. Public employers are different. The State of Maryland, like the overwhelming majority of state and local governments offers identical benefits to its employees at all levels. We are not a profit making entity offering a disproportionately high compensation package to high-powered executives at the expense of lower paid employees. Instead, from top to bottom, Maryland State government comprises public employees who traditionally have sacrificed personal gain for public service and the satisfaction it provides. There are no distinctions made among the benefits packages available to any employee at any level. Section 89, even with the revision currently before this Committee, imposes an enormous expense and compliance burden on plans which were never the source of the abuses targeted by the drafters of this code provision. Since funds earmarked for state employee benefits are limited, diversion of funds to document Section 89 compliance will most certainly reduce the amount of funds available to purchase benefits for our employees. Surely, this was not intended by the authors of the original legislation. We believe the expense and burden of compliance with Section 89 by state and local plans addresses a non-existent abuse and results in an unwise use of taxpayers' dollars. We further believe that granting this exemption would have no impact on the revenue expected to be realized under these provisions as we know of no public employer whose programs are designed in such a manner as to disproportionately favor their more highly paid employees. In fact, we believe the reverse will happen. The costs of compliance will of necessity have to be drawn against our already strapped budgets and will result in a greater need for federal support of programs serving the critical needs of our states and localities.

If the Committee does not believe it is possible to exempt state and local governments from the Section 89 eligibility and testing requirements, there are several areas of concern with both current law and H.R. 1864 which should be addressed to ameliorate the most onerous provisions of this law. I believe the Committee will wish to address these concerns once they are brought to your attention.

First and integral to the legislation, is the definition of "employee." As a public employer, we use inmate labor for some of our state projects. Inmate labor is unique to the public sector and is an integral part of our rehabilitation efforts. Under the Inmate Labor Program inmates are taught job skills which are critical to their successful transition from incarceration to freedom, and an essential component in our efforts to keep recidivism down. Inmates receive wages and the state pays Social Security taxes on those wages. Inmates are not eligible for the State Employees Benefits Plan and are not insured through the employees' medical plans. However, they do receive free medical care for the duration of their incarceration. Are inmates to be counted as employees when the State performs the various eligibility tests? We think not. Yet as the current definition reads, it would appear that they should be included in our calculation. If they are, then we would be hard pressed to continue our inmate labor program at the expense of our State workforce.

A similar question exists for employees of sheltered workshops. These disabled citizens of our State receive a monetary incentive to perform simple tasks commensurate with their abilities in a sheltered setting. They are not eligible currently for our employee health plan and may receive health care from a variety of sources, including Medicaid. Again, this category of "employee" is unique to the public sector. Without these programs which are directed at building self-esteem and re-enforcing self-confidence and independence these individuals would require extensive Federal and State support systems. Are they to be included when the State performs its eligibility tests? Here, again, we would be hard pressed to continue these efforts at the expense of the State workforce.

The State of Maryland hires a considerable number of persons under contract to perform time limited tasks -- tasks for which the regular, classified employment system is not suitable. In this respect, we are not dissimilar to the federal government. One area in which contractual employees are frequently used is in staffing projects funded by grants from the federal government and other sources. Benefit costs are not included in grant proposals. Contractual employees are permitted in our medical plans only if they employee pays the full premium cost from post-tax compensation; the State of Maryland does not contribute any portion of the premium. Indeed, an integral component of the independent contractor relationship is the is the understanding that the contractor is responsible for all his/her benefits costs, including pension and health benefits. The contractor's costs for providing these benefits is factored into the amount the contractor agrees to as satisfactory compensation for work performed. If contractual employees are to be included within the definition of employee under the eligibility test in Section 89, the State will be forced to contribute to the contractual employees' plan or fail the eligibility tests. To extend benefit coverage to these individuals under the same terms and conditions as other State employees will increase the cost of administering these grants by an estimated 30% - 40%. Likewise because of the short term nature of these contractual relationships we will be faced with increased benefits costs as our plans are adversely selected against by those contractors most in need of certain services. These increased costs will not only impair our ability to satisfy current grant requirements as we reduce the use of this employment option, but will have a dramatic effect on future federal grant requests to accommodate the increased costs associated with funding full-time positions.

In Maryland, contractual employees do not appear in our permanent personnel records. Therefore, there is a limited amount of information available. Gathering data on these employees to comply with Section 89 requirements will be costly and time consuming, if not impossible.

Finally, on the issue of the definition of who is to be included in the eligibility tests, the State of Maryland permits small municipalities and jurisdictions to participate in its various health insurance plans in order that they may benefit from the group rate. They are not technically State employees and are not eligible to participate in the State employees cafeteria plan. Were these small jurisdictions not able to enjoy the economic benefits associated with tying their benefits costs to the State group rate, these satellites would not be able to afford the costs of providing benefits to their employees. Here is yet another area where the states, including the State of Maryland, are unique. Will these satellite employees, as we call them, jeopardize our position with regard to Section 89? If so, again we would be hard pressed to continue these arrangements which benefit local jurisdictions and their employees at the expense of the State workforce.

In addition to the definition of "employee," the definition of "highly compensated employee" also creates a problem. In the Baltimore-Washington area - and other urban centers in the country - a $50,000 annual salary is not a "high" compensation. In this area, $50,000 would likely be termed a middle class income for a family. Since the tax penalty for a "highly compensated employee" can only be based on individual salary, a single income family will be disproportionately stung by the additional tax burden imposed by this legislation.

Another major area of concern with the proposed legislation is the cap on employee contributions to health care coverage. The State of Maryland contributes an amount which equals 85% or more of the average premium among all plans for each coverage level (individual, employee and child, employee and spouse, family). Even at this high rate of subsidy, the employee contribution to our most generous indemnity type plan exceeds the dollar caps listed in the proposed revision. The fact that the cap is tied to the Consumer Price Index rather than a medical inflation index means that the cap will always lag behind true medical inflation increases. If the employer cannot afford to increase its subsidy of the medical insurance plans, the alternative is to decrease the benefit by a re-design of the plan or to offer only managed care options (Preferred Provider Plans, Health Maintenance Organizations). Even in a State as geographically small as Maryland, there are rural areas where managed care programs are not available. Employees in these area will be forced to pay the penalties (higher co-pays) for using non-participating providers. In states with larger geographical areas and less concentrated populations, this problem is exacerbated. Since our retirees, many of whom live out-of-state, have the same plans available to them as we offer to our employees, retirees will also be penalized if managed care programs become the only alternative which the State can afford.

Finally, the proposed caps, and other features of both the current provisions of Section 89 and the proposed legislation, serve to discourage employers from offering flexible, or cafeteria-style benefits programs. These programs tend to be more sensitive to the needs of the workforce, particularly in view of changing demographics such as more two income families, and more single heads of household, particularly women with children returning to the workforce. A wide variety of plans makes it more economical and desirable for employees to have some kind of coverage. Yet this very diversity makes data gathering and testing from Section 89 an expensive and incredibly time consuming process. Forcing employers, by burdensome documentation and impossible standards, to return to the "one employer, one benefit plan" mentality will seriously injure many segments of the workforce -- in most cases, the very segments the legislation was intended to protect.

We urge you to give consideration to our concerns and to join several of your colleagues who have called for the repeal of

STATEMENT OF THOMAS B. WHEELER

PRESIDENT AND CHIEF EXECUTIVE OFFICER

of

MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY

Springfield, Massachusetts

I am Thomas B. Wheeler, President and Chief Executive Officer of Massachusetts Mutual Life Insurance Company. I appreciate the opportunity to present this testimony to the Committee.

Mass Mutual, organized in 1851, is the 11th largest insurance company in the United States. It sells individual policies of life insurance and annuities and group life and health insurance. Its policyholders are in all 50 states and the District of Columbia.

As a group health insurer, Mass Mutual does business with employers that range in size from fifteen employees to five thousand employees. We have learned first-hand how the complexities of Section 89 have confused employers of every size and type of business. We have also observed how the provisions of Section 89 have discouraged the introduction of cost containment programs, improvements in coverage, supplemental insurance plans and the expansion of coverage. Instead of working on innovations in group health programs, employers have been obsessed with finding ways to reduce the number of "Section 89" plans that must be tested.

Therefore, I would like to commend Chairman Rostenkowski and the cosponsors for their introduction of H.R. 1864. I would also like to commend other members of Congress who have expressed their concern regarding the problems of employers who have been struggling to comply with the requirements of present law.

Although Mass Mutual supports the simplified testing approach embodied in the bill, we believe that many employers will have problems complying with some of the requirements of this simplified test. It would be unfair to penalize employers who have done everything possible to provide coverage to a broadbase of employees. Thus, we recommend several changes to H.R. 1864.

FIFTY PERCENT LIMIT ON PREMIUM CONTRIBUTION RATHER THAN DOLLAR LIMITS

Currently, H.R. 1864 would cap the premium to be paid by a non-highly compensated employee to ten dollars per week for individual coverage and twenty-five dollars per week for family coverage. These amounts would be indexed to Social Security cost of living adjustments. The problem is that the medical inflation rate historically has risen at a greater rate than cost of living ladjustments. At the present time, the dollar limits are high enough for many plans to pass, but they will not remain so even though the caps are indexed to Social Security cost of living adjustments.

The IRS and some members of Congress may believe that employers, especially small employers, may be tempted to establish high premium contribution levels in order to discourage participation by non-highly compensated employees. A 1988 report on health insurance and the uninsured published by the Congressional Research Service contains statistical facts which suggest otherwise. Employee contributions are generally determined by the amount of money employers have available to pay for health coverage. See Health Insurance and the Uninsured: Background Data and Analysis, June 9, 1988, pp. 102-110.

The report states that the average total monthly premium in 1987 was $77 for individual coverage and $201 for family coverage. Forty-two percent of the individual rates were between $60 and $79 a month. Forty-four percent of the family coverage rates were between $160 and $219 a month.

The study also states that premiums for any particular plan can be significantly higher or lower than the premiums for another plan with identical benefits because of factors unique to the employer.

One important factor is location. Differences also arise from the demographics of the group. If an employer has a work force which is younger than average, it will probably have lower costs than average.

Premiums will also fluctuate with the claim experience of the group for larger employers. The true long-term cost of a plan is the premium needed to cover the claims and administrative costs, less investment income earned on premiums. If the claim and administrative expenses are greater than premium income in a given year, the insurer may recover deficits through future rate increases. Conversely, excess reserves from favorable experience will be used to reduce future premium costs.

The study found that employers typically require less than one-fourth of the cost be paid by the employee. Only three percent required a contribution of more than thirty-five percent of total cost. About a third of employees pay the total premium for dependents. Plans that require the employee to pay a share of the additional dependent cost typically require payment of a fourth of the cost. Four percent of plans require employees to pay the entire cost of dependent coverage.

Sixty-one percent of large employers and seventy percent of small employers pay the full cost of the health plan for individual coverage, the report said. Only twenty-five percent of large employers pay the full cost of family coverage, compared to sixty percent of small employers and seventy percent of small employers who have fewer than ten employees.

Small employers are more likely to pay the full cost of the health care plan because of insurance company requirements which seek to ensure that most healthy employees participate in the plan to balance the cost of higher-risk employees. Insurers do not have the same requirements for large employers because non-participation of a few employees will not significantly affect the cost.

From 1982 to 1987, the average employee premium had risen thirty-five percent. As total premiums have risen, employees have had to pay a larger share because employers do not have unlimited dollars to spend on health coverage. In 1977 through 1983, two-thirds of employers paid the full cost of employee coverage and forty percent of the full cost of dependent coverage. By 1987, however, employers were paying the full cost for substantially fewer employees.

As medical costs continue to rise, employers, with only limited dollars to spend on health care, will ask employees to contribute more to their health coverage. If the rate of medical inflation could be brought under control, employers would be able to finance their plans with smaller contributions from their employees. Many believe, however, that it is not unreasonable to ask employees to contribute as much as fifty percent of the premium. Even with that level of contribution, group coverage would be a better "deal" for employees than an individual policy of health insurance. Individual policies are underwritten on an individual basis. Persons who have had serious illnesses may never obtain coverage or may be issued an expensive policy that contains riders which exempt certain illnesses from coverage.

Allowing employers to base premium contributions on a percentage of premiums dispenses with the need to index caps. It also gives employers enormous flexibility in financing their plans during periods of abnormal claim experience.

DEFINITION OF PART-TIME EMPLOYEES AND INDEPENDENT CONTRACTORS

Part-time employees should be defined as those working less than thirty hours per week. This is consistent with the eligibility requirements of many group insurance policies. If employers have to cover persons who work less than thirty hours, it will be difficult for many employers to obtain coverage for their employees.

Independent contractors should not be treated as leased employees or as persons eligible for participation in a plan for common law employees. In many cases, independent contractors (e.g., full-time life insurance agents) do not participate in the same plan with common law employees. The differences in coverage often reflect differences in the nature of the economic relationship with the sponsoring employer. Independent contractors are not so easily defined as highly and non-highly compensated employees, since the amount of their income is generally within their control and is not determined by the employer. Whether they have coverage is not determined by whether they are highly or non-highly compensated employees. Therefore, the social purposes of Section 89 would not be furthered by comparing their plans with the plan for common law employees.

CONCLUSION

We appreciate your consideration of our views. If we can assist you and your staff, please do not hesitate to call upon us.

The Honorable Dan Rostenkowski
U.S. House of Representatives
Chairman, House Ways & Means Committee
1102 Longworth Office Building
Washington, D.C. 20515

May 9, 1989

Dear Mr. Chairman:

We appreciate this opportunity to submit a statement for the record relating to the May 2-3, 1989 hearings on H.R. 1864, a Bill to revise Section 89. This statement is submitted on behalf of The Mead Corporation of Dayton, Ohio by Jeffrey R. Dundon, Senior Tax Attorney, at The Mead Corporation.

The Bill you introduced on April 13th that would replace Internal Revenue Code Section 89 with a new non-discrimination test. We believe that your legislation is a significant improvement on the present Section 89, and will greatly lessen the administrative and cost burdens required by the current section's non-discrimination testing requirements. Mead is firmly committed to the proposition that all employees should have health coverage and that it should be available on a non-discriminatory basis. However, we have several concerns about the Bill in its present form that need to be addressed.

Examples provided in the technical description of the Bill seem to recognize the use of cafeteria plans by employers to provide coverage to their employees. However, the proposed statutory language in the section of the bill on salary reductions does not appear to allow for such plans. Specifically, any salary reductions are to be treated as employer provided benefits to the Highly Compensated Employees, but as employee contributions by the non-highly compensated employees. Where an employer gives all employees a fixed number of dollars (based on whether the employee is married or single) to purchase one of several medical and dental plans with any excess company dollars to be paid to the employee, the Bill is not clear whether or not this arrangement is a salary reduction plan. Because the employee could receive the company money as taxable compensation if he elected out of coverage an argument can be made that it is a form of salary reduction. We are firmly convinced that such a plan is non-discriminatory, especially if the true "out of pocket" cost to the employee is less than the $10 per week single or $25 per week family cost allowed in the Bill.

We suggest that these types of employer contributions not be considered "salary reductions" but rather employer contributions for purposes of the bill.

To that end, the Bill should be amended by adding to section (e)(3)(C) a provision that states "any amounts allocated to employees on a non-discriminatory basis for use in selecting optional forms of core health coverage shall be treated as an employer provided benefit for both the highly compensated and non-highly compensated employees." Also, a statement in the bill description and an example could be used to clarify that these monies are employer provided benefits and not employee contributions. Example 3 under the Benefits Test section of the technical description could be easily modified to demonstrate this concept. A similar example should be added to the Eligibility section of the description to demonstrate that the funds are not to be used in calculating the employee cost.

The Bill also appears to restrict the use of Flexible Spending Accounts by the highly compensated employees regardless of the availability or actual use of such accounts by the non-highly compensated employees. This also occurs because of the application of the salary reduction rules in the Bill. Since salary reductions are treated as employer provided benefits to the highly compensated, they are effectively capped at 133% of the benefit provided to the non-highly compensated employee. Since the non-highly compensated employees' payments are considered employee contributions under the Bill, this legislation may have the ironic effect of eliminating the use of a Flexible Spending Account for the non-highly compensated employees. For example, an employer provides a health plan to all its employees for $10 per week for single coverage and $25 per week for family coverage. The cost of the plan to the employer for each employee is $4,000. In addition, the employer allows contributions to an FSA to the extent that such contributions are permitted under Section 89. Since the non-highly compensated are at the maximum amount allowed to qualify the plan, the employer would not allow any contributions.

However, the highly compensated could contribute an additional $1,320 for non-covered medical costs. ($4,000 x 1.33 - 4,000 = $1,320).

We suggest that the easiest way to cure the problem is to treat salary reduction amounts the same for all employees to the extent that they do not exceed the employer cost of the qualified plan after eliminating employee contributions. This would also cure the problems for cafeteria plans addressed above.

Another area of concern is the reliance on the Secretary of Treasury to provide regulations on the testing of former employees. The general hue and cry about Section 89 and other sections of the Code amended by the Tax Reform Act of 1986 has been brought about by regulations issued by the Treasury Department. If the Bill intends to have the employer test former employees separately, you should clarify exactly which former employees you are concerned about. Is it the intent of this bill to cover all individuals that have separated from service, or is the bill simply referring to retirees? If the thrust of the Bill is to apply the non-discrimination rules only to retirees, then we suggest that the language be amended to say that. Mead is concerned that the Regulations will sweep up a greater number of former employees that should not be included in testing.

Also, it is not clear from the Bill which group of highly compensated employees is to be limited when testing former employees. Is it the high compensated former employees or the current employees?

Mead also believes that any nondiscrimination testing of leased employees should be delayed until after the issuance of final Regulations under Internal Revenue Code Section 414(n). The current regulations cost a too broad a net, that captures not only real leased employees, but bone fide independent contractors and employees of Fortune 500 companies. Clearly such a result was not intended by Congress when you were trying to prevent the practice of leasing all the rank and file employees and thus avoiding pension benefit obligations on the part of the highcompensated owner.

While not a problem with the bill in its present form, we have been greatly concerned with the proposals to exempt small companies from Section 89. The rationale advanced for the original Section 89 was to prevent the offering of of health benefits in a discriminatory manner. Such a practice was found mostly among small business and professional organizations. Large employers have been providing free or inexpensive health care for their employees for years. While the top executives may have gotten a free physical or other de minimis added benefit, by and large the benefits were non-discriminatory. We are not requesting that Mead or any other large employer be exempted from the section's non-discrimination rules, only that those organizations which were viewed as the reason for creating the tests in the first place not end up exempt from the statute.

I would be pleased to work with you in drafting either statutory language, description language, or examples to help address the problems that have been raised in this letter. If you believe that it might assist the Congress we would be willing to testify before the Ways & Means Committee.

As we noted earlier, this bill is a major step in the right direction and our concerns can be addressed without diminishing the intent of the statute.

Sincerely,

Jeffrey R. Dundon

Jeffrey R. Dundon
Tax

JRD:tma

May 10, 1989

STATEMENT OF WILLIAM P. McCLURE AND WILLIAM D. HAWKINS III ON BEHALF OF THE MOTION PICTURE ASSOCIATION OF AMERICA, INC. ON THE SUBJECT OF H.R. 1864

On behalf of the Motion Picture Association of America, Inc., the following statement is presented for inclusion in the record of the hearings on H.R. 1864, a bill to simplify the nondiscrimination rules applicable to employee benefit plans under section 89 of the Internal Revenue Code. H.R. 1864 represents a significant improvement over current law and significantly reduces the problems facing the motion picture industry in complying with section 89. Nevertheless, while the bill represents a substantial improvement, major difficulties in complying with section 89 still confront the motion picture industry.

The bill replaces the current nondiscrimination tests of section 89 with a new 90-percent eligibility test. Because the four primary multiemployer health plans associated with the motion picture industry do not require employee contributions, the only real issue is whether the 90-percent eligibility test is satisfied. Under the bill, each of the motion picture industry companies will test each of the union plans separately. Thus, for example, Paramount Pictures Corporation ("Paramount") will be required to determine whether 90 percent of its union employees on whose behalf Paramount contributes to the Motion Picture Health and Welfare Fund ("MPHWF") are actually eligible to participate in the MPHWF.

The problem facing the industry companies is that the MPHWF has very complex eligibility rules that require information not available to the participating companies. The MPHWF has two eligibility rules: an initial eligibility rule and a continuing eligibility rule. For purposes of both of these rules, there are eligibility periods (i.e., six-month periods (approximately January 1 to June 30 and July 1 to December 31) during which a participant is entitled to receive benefits) and qualifying periods (i.e., six-month periods (approximately April 1 to September 30 and October 1 to March 31) during which a minimum number of hours must be worked for all the participating employers in the aggregate in order to receive benefits during the following eligibility period).

In order to initially receive benefits (or to receive benefits after not receiving benefits in the five prior consecutive eligibility periods), a participant will become eligible for benefits either (1) in an eligibility period subsequent to a qualifying period in which the participant worked a minimum of 600 hours, or (2) in an eligibility period subsequent to two consecutive qualifying periods in which the participant worked a minimum of 600 hours. For example, if Participant A worked a total of 600 hours for participating employers during the period from April 1 to September 30, 1989, Participant A would be entitled to receive benefits the following January 1 to June 30, 1990.

After satisfying the initial eligibility requirements, a participant will continue to receive benefits for each eligibility period so long as the participant worked 300 hours during the previous qualifying period. For example, Participant A will continue to receive benefits from July 1 to December 31, 1990, so long as Participant A works a minimum of 300 hours for participating employers during the previous October 1, 1989 to March 31, 1990.

Thus, under the MPHWF, a participant's eligibility must be redetermined every six months. Obviously, each participating employer will not have the information necessary to determine whether the participant is eligible under the plan on any given date except in those rare situations where the participant worked a sufficient number of hours for that employer during the previous qualifying period. The information necessary to determine each participant's eligibility to participate is available other than in rare circumstances only to the plan administrators. Therefore, the 225 participating employers will each have to obtain from the plan administrators of the MPHWF information relating to the eligibility of the approximately 20,000 union members in order to perform the 90-percent eligibility test.

Besides being administratively difficult, this places a burden on the employer to obtain information from the multiemployer plan administrators in order to perform the 90-percent eligibility test. We believe it is unfair and oftentimes unrealistic to require employers to obtain information from the multiemployer plans in order to conduct the nondiscrimination test. This difficulty was recognized in the Technical and Miscellaneous Revenue Act of 1988 where several concessions were made to employers participating in multiemployer plans to reduce the amount of information needed from the multiemployer plan administrators to perform the tests required by section 89.

We believe multiemployer health plans should not be subject to the nondiscrimination test of H.R. 1864. Under H.R. 1864, multiemployer plans are allowed to be tested separately. We do not believe there is any evidence to suggest that multiemployer health plans discriminate between their highly-compensated employees and their nonhighly-compensated employees. Because the purpose behind section 89 is to prevent discrimination in health plans, no purpose is served by requiring multiemployer health plans to be tested for nondiscrimination since there is no evidence to suggest that a discrimination problem exists in multiemployer health plans.

As an alternative, we believe that it would be more appropriate to have the multiemployer plan administrators perform the nondiscrimination test for all the union employees. This approach would place the burden of testing upon the party who has the information necessary to conduct the testing.

If an exemption is not granted for multiemployer health plans and the participating employers are required to test their employees' participation in these plans, we believe a provision should be inserted that would provide that, for purposes of testing multiemployer plans under the 90-percent eligibility test, a participant in the plan is deemed to be eligible under the plan if the testing employer contributed to the plan on behalf of the participant for work performed on the testing date. This provision would allow the employer to perform the nondiscrimination test of section 89 based on facts within its own knowledge, instead of having to rely on obtaining the necessary information from the multiemployer plan administrators. While such a provision would not afford the absolute accuracy of actually determining whether a participant was in fact eligible to participate, such slight inaccuracy easily can be justified by the fact that the employer is actually funding the cost of health benefits. The fact that the multiemployer plan might have unusual eligibility rules that do not allow a participant to participate even though the employer is contributing on behalf of the participant should not prevent the plan from satisfying section 89 vis-à-vis that employer. The employer is satisfying one of the purposes behind section 89 by contributing to the multiemployer plan on behalf of the participant.

In addition to problems with obtaining information necessary to perform the nondiscrimination test, other significant problems exist under H.R. 1864. The ability of a motion picture industry company to satisfy the 90-percent eligibility test of section 89 will depend entirely on its "luck" as to whom it hires on the testing date. If a company is fortunate enough to hire a sufficient number of union employees on the testing date who are eligible to participate in the MPHWF to satisfy the 90-percent eligibility test, that company's highly-compensated employees will not be subject to taxation of their health benefits. However, a less fortunate company might unknowingly hire a sufficient number of union employees on the testing date who are not eligible to participate to fail the 90-percent eligiblity test, and thus its highly-compensated employees will have amounts included in income attributable to their health benefits.

This result occurs because of the fact that the union employees do not work for a single employer. Instead, section 89 is testing a company's employee's participation in the multiemployer plan based on the random set of employees who happen to work for the employer on the testing date. Thus, the results of the test are not primarily dependent on plan design, but upon random chance based on the employees hired on the testing date. Such an application of section 89 defeats the purpose of the design-based test of H.R. 1864 and will likely create unintended results.

An employer who fails section 89 would have to determine which of its employees were highly compensated. Due to the fact that virtually all the employees work for more than one employer in the industry, the number of employees treated as highly compensated for that employer will not present an accurate picture of which employees in the industry are truly highly compensated. For example, a union employee might earn $100,000 per year, but may have only earned $25,000 from the employer who failed the test. Thus, this employee would not be treated as highly compensated vis-à-vis that employer, while another union employee earning $60,000 per year having worked only for the employer failing section 89, will be treated as highly compensated, and will have amounts included in his or her income. This result makes absolutely no sense because the lower-paid employee, who is receiving benefits identical to the higher-paid employee, will have amounts included in income, while such amounts are excluded from the income of the higher-paid employee. Such a result reinforces the fact that the application of section 89 on an employer-by-employer basis to the multiemployer plans covering the motion picture industry employees does not serve any legitimate purpose and is likely to create gross inequities.

In then determining the amount to be included in income, employer contributions do not serve as an adequate measure of value since the test looks only to a single employer's contribution to the plan. Thus, without making adjustments (for which no guidance has been issued), a highly-compensated employee who works the entire year for the employer failing section 89 would have twice as much included in income as a highly-compensated employee who worked one-half as many hours for that employer, but received the same benefits.

The application of section 89 (if amended in accordance with the bill) to the multiemployer plans representing employees of the motion picture industry will produce unwarranted and unfair results. These problems should be corrected either by exempting these plans from the application of the nondiscrimination test of section 89, by requiring the multiemployer plan administrators to conduct the testing, or by treating an employee as eligible to participate if contributions are made by the employer on his or her behalf.

In addition, H.R. 1864 changes the sanction for failure to satisfy the qualification rules from a tax on the employees to a 34-percent excise tax imposed on the employer. While in general this change more properly punishes the offending party, it serves an injustice to employers contributing to multiemployer health plans. Such employers do not administer these plans and have no control over whether the plan satisfies the qualification requirements. We believe that the multiemployer plan administrators are the proper party to be penalized for any failure to satisfy the qualification rules because they control whether or not these rules are satisfied.

William P. McClure
William D. Hawkins III

McClure & Trotter

STATEMENT OF THE MOTOR VEHICLE MANUFACTURERS ASSOCIATION OF THE UNITED STATES, INC.

The Motor Vehicle Manufacturers Association of the United States, Inc. (MVMA), whose members produce 97 percent of all domestic motor vehicles, supports the objectives of H.R. 1864, a bill to amend the Internal Revenue Code of 1986 to simplify the antidiscrimination rules applicable to certain employee benefit plans. MVMA believes that the bill would help simplify the recordkeeping requirements and lower the cost of compliance. However, MVMA believes that some provisions of the bill need further refinement. Specifically, MVMA asks that the provisions related to union employees, salary reduction contributions, leased employees, and former employees be reexamined.

Union Employees

Section 89(e)(8)(A) of H.R. 1864 reads, "If an employer has employees included in any qualified bargaining unit, this section shall be applied separately with respect to employees included in each unit." This section disadvantages employers with union employees.

Some proponents of H.R. 1864 have said that separate testing of union employees parallels pension nondiscrimination rules, within which bargained employees are tested separately. However, pension rules, partly in recognition of the effects of separate testing, impose a 70 percent standard. It is misleading, at best, to copy the separate pension testing of union employees without also adjusting the tests accordingly as is done for pensions.

The social objective of Section 89 is to assure a fair balance of benefits between highly and non-highly compensated employees. In the motor vehicle manufacturing industry, the health care benefits of a significant number of non-highly compensated employees are subject to collective bargaining. If these employees are excluded when testing remaining employees, the result may not reflect the true balance of benefits between highly and non-highly compensated employees. Section 89 test results should not depend on whether rank-and-file employees in an industry are unionized.

Further, the proposed rule has great potential for disadvantaging some groups of employees versus others working for the same firm. Because bargained and nonbargained employees would be combined for the purposes of identifying highly compensated employees, but separated for testing purposes, it is likely that a greater number of nonbargained employees would be subject to added taxes on benefits than would be the case if the group were combined.

Companies which operate in industries characterized by heavy unionization of rank-and-file employees should be able to elect to take those employees into account in their 90 percent eligibility test under Section 89 without mandatory segregation based on bargained status. This election would be binding and could only be changed with the consent of the Commissioner. This could be done by including language in Section (8)(A) that employers may include union employees in their eligibility test.

Salary Reduction Contributions

As proposed under H.R. 1864, Section 89(e)(3)(C) provides that any contribution by reason of a salary reduction arrangement would be treated as (i) an employer contribution to determine a highly compensated employee's employer-provided benefit, but (ii) an employee contribution for purposes of subsections (b)(2)(A)(ii) and (c).

The bill's proposed 133 percent test identifies the cost of benefits available to 90 percent of the rank and file employees (base benefit). This base benefit is multiplied by 133 percent to determine the maximum nontaxable benefits for highly compensated employees. Under H.R. 1864 salary reduction contributions would not be included in the base benefits when determining the highest nontaxable benefit. However, the actual benefit provided to a highly compensated employee would include such salary reduction contribution to determine the taxable portion in excess of the 133 percent amount.

This treatment of salary reduction contributions, for some companies, is inconsistent and excessively harsh. The result is that non-highly compensated employees may receive greater nontaxable benefits than highly compensated employees even though the 133 percent benefits test would appear to allow a 33 percent disparity in favor of the higher paid.

For purposes of the 133 percent test, we request that you consider the following alternatives, each of which provides a reasonable allowance to highly compensated employees for salary reduction contributions.

1. Distinguish employer-provided cashable credits under Section 125 cafeteria benefit plans from other salary reduction contributions. Allow existing Section 125 nondiscrimination tests to govern the use of cashable credits, and provide uniform treatment of credits for highly and nonhighly paid employees.

2. Codify the position reflected in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and Q&A-8 (c) of the Proposed Regulations under Section 89 that salary reduction contributions are not required to be treated as employer contributions unless there are no true employer contributions. For example, treat salary reduction contributions as employer contributions where more than 50 percent of the value of the total core benefit attributable to employer contributions is paid from salary reduction contributions.

3. Increase the 133 percent multiplier to 200 percent, which would be consistent with the 90 percent/50 percent eligibility test under existing law.

Leased Employees

H.R. 1864 provides that leased employees do not have to be counted if the leasing company makes available affordable core health coverage. This provision does not adequately address a very serious problem. The problem is that, in most cases, an employer cannot determine who its leased employees are. For example, under current law, it is impossible to determine whether a company's leased employees include the employees of its suppliers, the employees of a construction company that it hires to build a plant, or the employees of a commercial laundry that it uses to launder the uniforms worn by its own employees.

The Treasury's proposed leasing regulations have completely failed to provide the specific definition that employers need. To make matters worse, the regulations also have gone beyond the intent of Congress to treat as leased employees many individuals who never were intended to be covered.

MVMA urges that the bill be revised to provide that leased employees will not be taken into account until plan years that begin at least one year after the publication of the final employee leasing regulations.

Former Employees

The bill delays the rules for former employees for one year. Although MVMA welcomes the one year delay, Section 89 should not apply to former employees at all until Congress fashions appropriate rules for them. Unlike current employees, former employees do not have regular contacts with their former employers. As a result, most employers do not have the information that will be required if the availability standards that apply to current employees also are applied to former employees.

In addition, postemployment benefits typically depend on two factors: the type of termination, and the length of service while employed. Few employers would pass the 90 percent test across the entire range of former employees, which can include voluntary terminations. Drafting appropriate rules is most difficult for retiree health care, for which most companies require a minimum of service to qualify (such as 10 years). This critical issue should not be left to regulations. We urge that former employees be excluded from testing until a Congressional study of the issue has been completed. We also believe that former employees should be included prospectively.

In addition, MVMA and its member companies have concerns with other provisions in H.R. 1864.

- Accidental death and dismemberment coverage and business travel accident insurance should be excluded from Section 89. We suggest these items should be covered under separate rules, possibly the nondiscrimination rules of Section 79.

- The penalty for failure to comply with the qualification requirements is excessive. There should be both a *de minimus* and good faith exception. A two-tier penalty system would also be appropriate.

- In valuing benefits for testing, when cost-based methods are used, geographic, utilization and demographic disparities should be able to be taken into account on a good faith basis.

- The transition period provided to use old rules should be lengthened.

- The nondiscriminatory provision test should be written as in the present legislative history to apply only to terms which are nonquantifiable.

- In determining taxable income an employer should have the option to elect that the provisions ought to provide true one-day testing; for example, similar to determination of marital status at the end of the year.

MVMA would welcome any questions on these points.

NACSA
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April 26, 1989

The Honorable Dan Rostenkowski
Chairman
House Ways & Means Committee
1102 Longworth
Washington, D.C. 20515

Dear Mr. Chairman:

The National Association of Casualty and Surety Agents (NACSA) represents the nation's leading 300 property and casualty insurance agents and brokers, specializing in the sale of commercial insurance products. On behalf of NACSA, we are writing to notify you of our support of efforts to simplify the complex provisions of Section 89.

We want to emphasize that NACSA fully supports nondiscriminatory employer-provided benefits. We believe Congress has presented the private sector with a worthy goal: that in order to retain the tax advantages of employer-provided benefits for both employers and employees, employers must strive to make their benefit packages nondiscriminatory.

In practice, however, our concern with Section 89 is that it has created an overly cumbersome compliance standard and testing process. The cost and burden of proving nondiscrimination in one's employee benefit programs may well tempt some employers to circumvent the statute rather than undertake the testing process.

We applaud the Committee's current efforts to simplify the statute in a way that employers can fulfill Congressional intent without promoting a burdensome and expensive compliance process.

Sincerely,

John A. Kohler
John A. Kohler, CPCU, ARM
President

(Chairman, Brandow Howard
Kohler & Rosenbloom, Inc.
Minneapolis, Minnesota)

Ken A. Crerar
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Vice President
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/alg

Section 89 and H.R. 1864
on behalf of the
National Association of Manufacturers
Submitted to the
Ways and Means Committee
U.S. House of Representatives
May 2, 1989

Mr. Chairman and members of the Ways and Means Committee, we are pleased to submit this statement on Section 89 and H.R. 1864 for the record. You are to be commended, Mr. Chairman, for proposing H.R. 1864 to modify Section 89 and for holding hearings to call attention to the serious problems created by Section 89 and its adverse impact on the provision of employee benefits.

Below, we comment on H.R. 1864, which we believe, offers significant legislative relief for some employers. However, we remain convinced that the feasibility of accommodating the diverse nature of employment, benefit, and industrial patterns across the U.S. remains nearly an impossible task. NAM which includes over 13,000 members with both Fortune 500 Companies and smaller firms is a clear demonstration of this diversity. Within our membership, 9,000 firms have an employee base of under 500 workers and a large percentage of these have fewer than 100 workers. Trying to accommodate this diversity compels us to urge repeal of Section 89 (H.R. 634/S. 350, LaFalce D-NY, Lott R-MS) and return to previous 1986 law.

NAM has long advocated nondiscrimination in the provision of employee benefits as sound employee relations and economic policy. Section 89 runs contrary to that goal and is having a negative impact on all businesses that offer employer-sponsored health and welfare benefits. If discrimination is of paramount concern, some, including Senator Heinz (R-PA), have suggested that employers sign a simple declaratory statement indicating they do not willfully discriminate in providing employee benefits. We would support this approach.

CONGRESSIONAL INTENT VS. ACTUAL EFFECT OF SECTION 89

The Tax Reform Act of 1986 (PL 99-514) added IRS Code Section 89 to require all employers--private firms, as well as state, local and federal governments and nonprofit entities--to test their tax-exempt employee benefit plans (accident, health and group term life insurance) to determine if such plans favor highly compensated employees over the rank-and-file. Recent IRS interpretations, however, have exempted the federal government, which seems unfair and further demonstrates the difficulties of this law. The employer is presumed guilty until proved otherwise, contrary to usual American justice which presumes innocence until proven guilty. Firms which voluntarily provide benefits must meet stringent requirements, while firms not offering such protection to their employees escape these costly administrative burdens. In a time when public policy should encourage expansion of coverage, this legislation accomplishes the exact opposite.

To conduct the testing, employers must collect, analyze, maintain and update massive amounts of data. The data must then be subjected to a series of complicated eligibility and coverage tests. Penalties include taxing the health benefits of highly-compensated employees deemed in discriminatory excess. Employers who fail to disclose this information are subject to an excise tax on the amount of plan benefits that are deemed to be discriminatory.

As originally conceived, Section 89 was intended to encourage greater expansion of employee benefits, particularly health insurance, to more lower-paid and part-time workers. Yet, proponents of this provision now argue against repeal of Section 89 because it would constitute a loss in tax revenue which would have to be offset to comply with Gramm-Rudman-Hollings targets. If the orginial intent of the statute had been achieved, then employers would be able to comply with this legislation, expand benefit coverage and no penalties would be collected. These apparent conflicting objectives further underscore the flawed nature of this statute.

Failure to pass the tests leave few options available to employers, a circumstance which raises serious questions. Some employers may choose to increase the salary of the highly-compensated employees deemed in discriminatory excess, rather than change all benefit plans for the rank-and-file. Shifting these moneys from the corporate tax side to the individual side would not achieve the policy objective of ensuring plans are nondiscriminatory; and would yield less revenue because individual tax rates are lower than corporate rates.

No hearing record, or evidence other than anecdotal, exists to demonstrate that widespread plan discrimination existed to warrant special rules. No votes in either the House or Senate were taken on Section 89. Ironically, this new rule may well have the opposite effect and reduce health benefit options, reduce employer-provided dependent coverage or eliminate employer-sponsored coverage altogether. If Congress is genuinely serious about discouraging discrimination, then hearings should be held to gather information on the extent and nature of suspected problems and types of possible solutions.

The premise of Section 89--extending ERISA's nondiscrimination rules for pensions to welfare benefits--does not work. Health insurance and pension plans are completely different products--for example, pension benefits rely on fixed pay-outs in retirement while health benefits are subject to major inflationary swings, demographic factors and continual medical technological developments.

The impact of Section 89 as it affects the provision of employer-sponsored health benefits must be carefully studied. To date, use of the tax code with incentives to encourage health benefit coverage has worked well with over 85 percent of American workers and their families now receiving health insurance. More specifically, the Bureau of Labor Statistics in 1986 reported that 95 percent of medium to large firms provided health insurance.

For small business, however, coverage is less widespread. A survey of 1,439 firms with fewer than 100 employees conducted by the National Federation of Independent Business (NFIB) in 1985, showed that 65 percent offered health benefits. This was an increase from 57 percent reported in 1979.

The NFIB findings are consistent with findings of a similar survey conducted by the U.S. Small Business Administration in 1986. In service and retail industries, slightly over one-half offered health benefits, while for manufacturing, 83 percent offered such coverage. Preliminary findings from a recent NAM survey of over 2,000 manufacturing firms show that of companies with 25 to 50 employees, 96.3 percent offered health benefits to workers and 94 percent also made coverage available to dependents.

Given these difficulties and the fact that there are an estimated 30 to 37 million persons without health insurance--a sizable portion of whom have some connection to the workforce--it seems ill-advised to discourage firms from offering employment-sponsored coverage. Rather, we need to pursue a national policy encouraging expanded coverage including minimizing regulation: for example--eliminating Section 89 and encouraging group purchasing of health insurance (multi-employer trusts); providing an ERISA exemption of state mandated benefit laws; and offering special tax incentives to very small and/or start-up businesses.

SECTION 89 AND SMALL BUSINESS: SUPERIOR TECHNICAL CERAMICS A CASE STUDY

The workforce of Superior Technical Ceramics in St. Albans, Vermont includes 85 people, 15 of whom are salaried. Several of the latter are specialized engineers. Benefits are provided on a nondiscriminatory basis. The costs and hours spent in Section 89 compliance thus far for Superior Technical Ceramics is considerable, including:

- o 15 hours spent in three training courses at a cost of $1,500.
- o Purchase of software with a projected price of $10,000.
- o Legal fees to obtain disclaimer statements from 85 persons, 15 minutes each, at $150/hour or $3,187.50.
- o Preparation of the testing plan (with 14 separate sections) by an outside accounting firm at cost of $10,000.
- o Analysis of education benefit program to determine if this plan comes under Section 89; costs unknown.
- o Total known costs to date: $24,687.50.

Given the complexities of Section 89, Superior Technical Ceramics was forced to hire a full time personnel manager at a salary of $28,000 yearly plus 40 percent for fringe benefits, a cost which must be added to the above. While this manager will not spend full time on compliance, Section 89 was the deciding factor in driving the company to hire an additional staff person.

Superior Technical Ceramics notes in its letter to Rep. Pete Smith (R-VT) that it is committed to meeting its corporate responsibility "by providing excellent medical, disability, maternity, life insurance and pension coverage to all its employees." It's testimony to the Senate Small Business Committee further comments: "A legal/regulatory system that frustrates this commitment is a sad commentary on America's free enterprise system and its basic societal values for a healthy and productive workforce."

OTHER EXAMPLES OF SMALL BUSINESS PROBLEMS WITH SECTION 89

Numerous companies have written NAM describing their experiences in attempting to comply with Section 89. Beisler-Weidmann Co., Inc., Belleville, New Jersey with 26 employees reported that its insurance company submitted a bill of $1000 plus $10 per employee to provide the company with an initial "snapshot" of the benefit program with future charges for retesting. Star Bronze Company, Alliance, Ohio, is a manufacturer with 50 employees which provides fully-company paid health insurance. The company has already spent hundreds of hours on research and document preparation at an estimated cost of $2,000 to $4,000. Inclinator Company of North America, Harrisburg, Pennsylvania, with 50 employees, will incur a cost of $1700 to $2500 plus an annual update fee to evaluate its life and health insurance benefits plans, according to estimates from its accounting firm.

While these compliance costs may not seem excessive to one accustomed to dealing with larger businesses, the amount of time and money as a percentage of the entire business operation must be appreciated. The aggregate amount of time and money spent by the numerous small businesses nationwide is indeed considerable. Such a use of resources is wasted and could be better spent in enhancing employee benefit programs or investing in new plant and equipment.

Attached to this statement and for inclusion in the record, are copies of letters on Section 89 received by NAM from numerous small firms as well as large companies.

H.R. 1864

Mr. Chairman, we appreciate your efforts in introducing H.R. 1864 and seeking to address the problems of Section 89. Particularly, we note these improvements: the change to a design-based plan, the move from actual participation to eligibility for the employer plan, simplification of the testing process, increase in number of hours worked for consideration under the nondiscrimination rules, and the leased employee safe harbor.

Other areas remain troublesome and will affect our larger company members and smaller firms in varying ways. The paragraphs below highlight these items.

- Employee Contribution Limits. Under H.R. 1864, employers could not require employee contributions above $10/week for the individual ($25 for a family) with changes tied to increases in the wage-based inflation index. Several problems are evident. Most critical here is the government's intrusion into an internal management decision--determining how much the employer must pay for health benefits provided to workers. Technically, this proposal has other flaws. The increase in the national average of total wages has not increased in the recent past nearly as rapidly as the medical component of the consumer price index (CPI). Tying the limits to the medical component of the (CPI) would be the better approach. Regional differences also affect the cost of health insurance across the country. Rather than a flat dollar amount, the use of a percentage of the health insurance premium to be paid by the employee is suggested.

- Part-Time Employees. While 25 hours per week is better than 17-1/2 for purposes of the rules, a 30-hour week has historically been used to separate full-time from part-time workers. Many insurance companies will not write insurance contracts below 30 hours per week.

- Eligibility Standard. H.R. 1864 requires that 90 percent of the rank and file be eligible to participate. This could prove difficult for many employers, for example, small employers or employers with a large number of unionized employees. Rather, a 70 percent standard could be used as in the case for pensions.

- Benefits Test. The proposed new benefits test--the 133 percent test is more difficult to satisfy than that of the existing Section 89. The new test limits each highly compensated employee individually to a benefit that may not exceed 133 percent of what is often the lowest benefit for any nonhighly compensated employee group with a distinct benefit. In contrast, present Section 89 provides that average benefits for highly compensated employees may not exceed 133-1/3 percent of the average benefit for nonhighly compensated employees. Return to the original less stringent standard is preferred.

- Cafeteria Plans. H.R. 1864 is particularly harsh in this area. Specifically, the proposal's determination of what constitutes employee contributions would disqualify many cafeteria plans. Employers who sponsor cafeteria plans often provide credits which employees may use to pay for coverage elected under the plan or may, under certain circumstances, take in taxable cash. Under H.R. 1864, such "cashable credits" are also considered employee contributions when determining whether the benefits provided to nonhighly compensated employees are affordable. In addition, these employer-provided funds are also considered employee contributions when determining the employer-provided benefits of nonhighly compensated employees for purposes of the 133 percent rule. Pre-tax salary reduction contributions are treated the same way. However, both cashable credits and salary reduction contributions are treated as an employer contribution when made by a highly compensated employee. By treating cashable credits and salary reduction amounts this way, H.R. 1864 almost guarantees that most, if not all, cafeteria plans will be held to discriminate.

- Compliance Date. Given the legislative uncertainties and lack of clear regulatory guidance on Section 89, we strongly urge that compliance be deferred until 1990 or reasonable time after regulations are final. Treasury's deferral date until October 1 for testing is an indication of the administrative difficulties perceived by the Department in enforcing this statute.
- Definition of Core Coverage. Under this proposed bill a qualified core health plan is an accident or health plan maintained by an employer which primarily consists of core health coverage, but "core" is not defined in this bill.
- Former Employees. Former employees should be excluded from Section 89 requirements. Post-retirement benefits are being addressed through FASB rules, Medicare legislation, etc. This is a particularly onerous requirement under Section 89. Also, there are no rules defined for testing this group.
- Dependent Care Assistance. H.R. 1864 eliminates the right to test for dependent care assistance under Section 89, resulting in application of the often much more elaborate requirements of Section 129. These rules are much more complicated than the nondiscrimination rules applicable to life insurance under the bill. One of the major steps forward under H.R. 1864 is the realization that benefits like group-term life insurance are not properly tested under rules designed for health insurance--the same is true for dependent care assistance.
- Leased Employees. Although H.R. 1864 provides a leased employee safe labor, the definition of leased employees remains much too vague and subject to interpretation.

CONCLUSION

H.R. 1864 is an improvement over current Section 89 in reducing complexity, but problems remain including employee contribution limits which are in effect--mandates on employers, compliance for cafeteria plans, 133 percent benefits test, and eligibility standard of 90 percent. Resolving these issues and others mentioned by additional hearing witnesses is a formidable task. We seriously doubt the feasibility of legislatively accommodating the diversity of employment, benefit and industrial patterns across the country, particularly in the absence of hard evidence substantiating widespread discrimnation.

Assuming that major modifications were enacted, there would still remain a formidable regulatory hurdle to the expansion of employer-provided coverage. Small business, which historically has lower coverage rates, will be further discouraged from offering health insurance and some may drop benefits altogether. The resources devoted to Section 89 compliance could better be spent on improving health care coverage for those without insurance.

The alleged intent of Section 89 was to discourage discrimination in benefits and expand coverage, an objective that must seriously be questioned as proponents of the statute insist that offsetting revenues be found. It appears to us that Section 89 is a backdoor approach to taxing employee benefits--a practice that threatens to undermine our voluntary system that successfully provides health and benefit security to millions of American workers and their families. Should discrimination be the concern, we would suggest that the law simply require employers to sign a statement indicating they do not willfully or to their knowledge discriminate in the provision of employee benefits.

For these reasons, NAM remains committed to the repeal of Section 89 as the best approach to encouraging the growth of employer-provided health insurance.

[THE LETTERS THAT WERE ENCLOSED WITH THIS STATEMENT ARE BEING RETAINED IN THE COMMITTEE FILES.]

NATIONAL ASSOCIATION OF REHABILITATION FACILITIES

Edmund S. McLaughlin
President

John A. Doyle
Executive Director

Dear Mr. Chairman:

This letter is submitted on behalf of the National Association of Rehabilitation Facilities (NARF). NARF is the primary national organization representing community-based nonprofit rehabilitation facilities that provide rehabilitation, training and placement and residential services to persons with mental or physical disabilities. Many of our vocational members employ less than twenty-five (25) people. Work is often an important part of the rehabilitation and training process for these people. There is a great deal of confusion surrounding Section 89. NARF has been inundated by calls from concerned members. Some callers think that mandated health benefits legislation has been passed; others have heard conflicting reports about what is required under Section 89 and all want to know what they should do.

We commend the Chairman and this committee for addressing concerns about Section 89. H.R. 1864 is a positive start, and it shows good faith upon which we may be able to build a solution to resolve this dilemma. Replacing the several nondiscrimination tests with a single test is a significant improvement. There are, of course, some concerns that remain.

The purpose of Section 89 was to encourage employers to expand similar benefit plans to all employees. The consideration and enactment of this provision have occurred at the same time that efforts have been made to increase health care coverage for the employed, as well as the unemployed. Unfortunately, Section 89 may have the ironic effect of impeding, rather than encouraging, these efforts. The provision has proven to be inordinately complex in its understanding, places a tremendous reporting burden on facilities, and data collection. The information would be used to determine whether benefit plans are discriminatory and, if so, the additional income that must be imputed to highly compensated employees (if any) who receive the discriminatory employer-provided benefits. Employers must maintain detailed personnel records identifying employees and dependents by a variety of categories and very few small rehabilitation facilities are equipped with data bases to handle this task. The regulations issued on March 7 by the Internal Revenue Service have done little to clarify numerous questions raised by the statute.

Since Section 89 was passed it has raised an enormous level of concern among both our vocational and medical rehabilitation facility members. Medical facilities, as with many other employers, are concerned about the general interpretation of Section 89. Vocational rehabilitation facilities in addition to having this level of concern have unique concerns regarding whether some workers with disabilities are to be considered employees for purposes of Section 89. It is this area in which we have our most serious concerns. Even though the Treasury Department has announced it will delay the beginning date for testing plans for compliance until October 1, these concerns remain.

There are two basic concerns that have been raised in the context of the vocational facilities. The first as noted, is the definition of who constitutes an employee for purposes of Section 89. The second question is who, among types of employees, should receive a different type of treatment under this section for reasons that are addressed below or who should possibly be excluded from the nondiscrimination rules of Section 89. The IRS recognized this issue in its March 7 regulations and invited comments on the question of excluding certain categories of employees, including those in sheltered workshops.

With respect to the issue of who is an employee, the IRS has addressed this issue with regard to the employment status of clients/workers receiving training and rehabilitation for purposes of FICA and Federal Income Tax withholding in Revenue Ruling 65-165. In summary, that ruling stated that where the training was to "rehabilitate and protect" and where there is no agreement to form an employment relationship there is not the "degree or kind of direction and control" that is necessary to establish an employer-employee relationship. In coming to this conclusion, the IRS reexamined the master servant test in common law. Also in that ruling, the IRS said that with longer term sheltered workers there was an employee-employer relationship evidenced by vacations, bonuses, and discharges for unsatisfactory work.

Subsequent to this revenue ruling there have been several private letter rulings dealing with additional fact situations and coming to similar findings. These include a Private Letter Ruling 8703014. We believe this distinction is logical and should continue. However, the IRS has not addressed this issue in the regulations, leaving 5,000 affected rehabilitation facilities in a total quandary, with the possibility for grave financial repressions. Section 89 raises other problems for people in vocational rehabilitation facilities who are employees. It seems implicit in Section 89 that employers are hiring employees because it is in the employer's interest to do so. In providing work and incomes for disabled people, vocational rehabilitation facilities are not guided by this motive. Rather, their purpose is a social one, to afford employment and dignity for people with disabling limitations. Under these circumstances the value of imposing the requirements of Section 89 to their client population must be gauged by whether it expands or restricts potential benefits to them.

Most vocational rehabilitation facilities employ staff to provide training, supervision, counseling, and other services to disabled people served by the entity. These employees would and should be covered by Section 89 to the same extent as other employees subject to the law. Persons with disabilities who are served by the facility pose special problems. Application of the tests set forth in Revenue Ruling 65-165 only partially address this problem. Institutions employing large numbers of person with disabilities who have completed a rehabilitation program face difficult choices if Section 89 is applicable to such persons. Many are covered by Medicare and Medicaid.

The economic effect of whether a person is an employee for purposes of withholding or Social Security is quite different from that of mandating participation in health and accident insurance, for example. In the latter case a physically or mentally disabled person may be an uninsurable risk on an individual basis and the presence of a substantial number of such persons in a facility may render the entity itself uninsurable or dictate premium rates that are not economical. Many such persons are entitled to Medicare benefits as a result of being disabled for two years or for Medicaid benefits as a result of their incomes or because they are beneficiaries of the Supplemental Security Income Program under the Social Security Act. There are complex interrelationships between income, disability and physical/mental condition in the eligibility standards and benefits in these programs. For example, the Medicare and Medicaid Acts provide that group or other health insurance is now the first payor. Yet, under certain circumstances persons with disabilities are allowed to retain Medicaid coverage while working after periods of rehabilitation or in a sheltered environment. (See Section 1619, Social Security Act.) There are over 5,000 affected rehabilitation providers serving well over 400,000 people in these categories.

In some cases special waivers have been granted to permit them to work without loss of these publicly supported health care programs. Requiring that the rehabilitation facility cover the full cost of such insurance will likely force, not the expansion of benefits for clients with disabilities, but rather the elimination of benefits for staff.

We do not have sufficient information on the contemporary practices of various facilities to provide a comprehensive statistical analysis of this problem, but it certainly exists. It is compounded by the fact that persons with disabilities often are uninsurable or are insurable only at high rates and with "preexisting condition" exclusions. It is unclear whether such an exclusion would be regarded as discriminatory per se under Section 89. It would also be a cruel irony if Federal law made the staff of a rehabilitation facility uninsurable as a group or priced them out of the market by requiring inclusion of disabled clients, who in many cases are covered by public programs. NARF supports provision of benefits especially health benefits, for persons with disabilities but does believe the Internal Revenue Code is the proper forum for tackling this problem.

We strongly suggest that persons served by rehabilitation facilities be excluded from Section 89 as not being the type of "employees" to which the law is addressed. We suggest that this exclusion extend to both persons in active training programs and those in sheltered or supported employment programs. At a minimum, certain definable populations should be excluded. These should logically include persons employed under Labor Department certificates pursuant to Section 14(C) of the Fair Labor Standards Act, persons receiving Supplemental Security Income payments, persons receiving Social Security Disability Insurance benefits and persons otherwise qualified for state Medicaid benefits. These groups are not exhaustive of the persons served in vocational rehabilitation facilities, but they constitute a considerable portion thereof.

It is our intention to supplement these comments as further information on the matter is developed. It is urgent that Section 89 not result in losses of benefits for current staff and impairment of services to persons with disabilities. To do so would defeat some of the original intent of Section 89. Those are the likely results of application of the law to clients in programs operated by vocational rehabilitation facilities. We recommend that H.R. 1864 be amended to assure that it does not inadvertently have the same result as current law.

Therefore in summary, NARF makes the following recommendations for final action on H.R. 1864:

1. NARF is requesting that the Committee direct the Internal Revenue Service to issue a ruling defining employees for purposes of Section 89, using Revenue Ruling 65-165 and subsequent private letter rulings as the basis for this regulation. Such a regulation should note that where the purposes of work is therapeutic and is part of a rehabilitation plan for the individual and the individual is not producing at levels that would be expected of regular employees and the other indicia of an employment relationship are not present then the person with a disability would not be considered an employee for the nonprofit service provider for purposes of Section 89.

2. NARF recommends that certain categories of employees be excluded for purposes of Section 89 only. As noted we suggest that this exclusion extend to persons in active training programs and those in sheltered or supported employment programs. At a minimum, certain populations should be excluded. These are persons employed under the Department of Labor certificates issued pursuant to Section 14(c) of the Fair Labors Standards Act, persons who are receiving Supplemental Security Income payments, persons receiving Social Security Disability Insurance Benefits, and persons otherwise qualified for state Medicaid benefits. While this is not an exhaustive list as noted above it constitutes a number of the persons served in vocational rehabilitation facilities.

3. NARF recommends the Committee seek to delay the effective date of this provision until one year after final regulations are promulgated with a statutory deadline for such final regulations based on any change in the statute made by the Committee. This would allow adequate time for all affected parties to have a better understanding of the final statute and any final regulations.

Carolyn C. Bollar, Esq.
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National Coordinating Committee for Multiemployer Plans

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MAY 2, 1989

TESTIMONY OF ROBERT A. GEORGINE, CHAIRMAN, NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS BEFORE THE HOUSE WAYS AND MEANS COMMITTEE ON H.R. 1864, A BILL TO SIMPLIFY THE NONDISCRIMINATION RULES APPLICABLE TO EMPLOYEE BENEFIT PLANS UNDER SECTION 89 OF THE INTERNAL REVENUE CODE

My name is Robert A. Georgine and I am testifying in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans.

The Coordinating Committee was organized shortly after the passage of ERISA in 1974, to represent the interests of the more than nine million working men and women, and their families, who are covered by multiemployer plans. The Committee's affiliates include more than 190 pension funds, health and welfare funds, and related international unions.

We applaud the effort made in H.R. 1864 ("Bill") to simplify the extraordinarily complex nondiscrimination rules applicable to employee welfare benefit plans under section 89 of the Internal Revenue Code. If interpreted and implemented in an appropriate and workable fashion, this Bill would vastly simplify the testing burdens imposed on most employers contributing to multiemployer plans. However, if interpreted or implemented without due regard to the unique nature and circumstances of multiemployer plans, the Bill could impose insurmountable burdens on multiemployer plans and be completely unworkable. Thus, the primary purpose of my testimony is to describe the unique nature of multiemployer plans and the interpretation of the Bill that is most appropriate and workable for such plans.

In addition, I would like to point out that, under current law, employers test the coverage they provide to members of a collective bargaining unit and the coverage they provide to other employees together. In some cases, the result is that the coverage an employer provides under a multiemployer plan helps the employer to satisfy the Code section 89 requirements with respect to other, nonmultiemployer plans. We suggest that you give consideration to permitting employers to elect to test their collective bargaining unit members and their other employees together for this purpose. However, the increased burdens of such combined testing should not be imposed on employers that do not elect it.

Finally, I will suggest a few technical changes to make the Bill more workable for multiemployer plans.

I. THE UNIQUE NATURE OF MULTIEMPLOYER PLANS

One of the things that makes multiemployer plan coverage unique from a section 89 perspective is the independence of the plan from any particular contributing employer. The plan's trustees design and administer all aspects of the benefit program. They set the eligibility rules, determine the specifics of coverage (covered services, coverage limits, etc.), decide whether the plan is to be insured or self-insured, etc. The plan may have hundreds of contributing employers. Some plans have contributing employers numbering in the thousands. A contributing employer typically does little more than send in its periodic contributions with whatever backup information is required to enable the plan to identify the employees to whom the contributions relate.

Employers, other than those on the boards of trustees, typically are not well informed about the details of the coverage provided under the multiemployer plans to which they contribute. Many of them may be contributing under agreements produced through collective bargaining in which the individual companies did not participate, because it was handled on their behalf by employer associations. Employers ordinarily do not have sufficient information to value the coverage provided to their employees for purposes of the section 89 nondiscrimination tests.

Another distinguishing characteristic of most multiemployer plans is the mobility of the employees they cover. Often their participants will only work for a brief period for any one contributing employer, though they are working continually in the industry during the year. For example, a construction worker may work for various contractors during a month, moving from one to another as he completes the specific job for which he was hired on each project. Many of these employees would never qualify for health coverage from any one employer. The multiemployer plan adds up their short periods of service with each employer and gives them coverage based on the aggregate.

Multiemployer plans are, by definition, maintained pursuant to collective bargaining agreements. The overwhelming majority of their participants are union-represented rank-and-file workers. Typically, only a small proportion -- if any -- of these workers are highly compensated employees. The plans provide uniform benefits in relation to contributions,[1] are virtually always noncontributory (100% employer-paid), and rarely, if ever, offer individual employees different coverage options (other than an HMO option).

Multiemployer plans do not have and ordinarily cannot get information about their contributing employers and their workforces necessary to test for compliance with Code section 89. The plans do not have information on the management structures of contributing employers or on the salaries and pay scales of employees, including employees who are not covered under the plan. In addition, they do not have information about leasing or affiliated service group arrangements in which contributing employers may be involved. They therefore cannot determine which, if any, covered or noncovered employees of those employers are highly compensated.

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[1] Some plans, particularly regional or national plans, offer different benefit packages for different rates of employer contributions. The choice is not made by individual employees, but by the various employers and unions through bargaining. Thus, for instance, if one group negotiates a $0.75 per hour contribution, that might entitle the employees of that employer to benefit plan A, while a $1.00 per hour contribution rate would make them eligible for the more generous benefit plan B.

Contributing employers would be extremely resistant to providing this information to the plans, the boards of trustees of which are required by law to be made up 50 percent of union representatives and 50 percent of employer representatives who, in most cases, are highly placed in the management of competitors of contributing employers. Further, as a practical matter, it would be impossible to compile and process this information for the hundreds of contributing employers that participate in the typical multiemployer plan.

Plans also do not have information about other plans maintained by contributing employers. Thus, they cannot determine whether those other plans cover individuals who would otherwise be excludable for purposes of section 89 testing. Such coverage would prevent similarly situated employees in a bargaining unit covered under a multiemployer plan from being excludable. Similarly, contributing employers would have no knowledge of or control over the plan's eligibility rules.

In addition, multiemployer plans have a fixed income. In the section 89 context, this is significant both from the employers' and the plans' perspectives. These plans are funded based on contribution rates fixed in collective bargaining agreements, which typically require employers to contribute a set amount based on some measure of the activity of covered employees. The standard, for example, is a requirement of $x per hour worked by an employee covered by the bargaining agreement. Those contributions are payable, typically, on all employees in the bargaining unit without regard to their coverage under the plan (This contrasts with an insured single employer health plan, where the employer does not pay premiums on behalf of an employee until the employee is covered. Of course, in a self-funded single employer plan, employer contributions are generally made as covered employees incur claims.) On the other hand, because of multiemployer eligibility rules, coverage is provided under the plan for some people for whom employers make no contributions.

From the plan's point of view, it is important that the employers only contribute what the collective bargaining agreements require them to, even if it turns out that the plan actually needs more. If the information that employers need for section 89 compliance is difficult and expensive for plans to develop, it could create real hardships for plans to provide it. Even if plans had the capability of assembling section 89 data, some may not be able to afford it without cutting the level of coverage.

II. A WORKABLE INTERPRETATION OF H.R. 1864

We applaud the Bill's provision for separate testing of bargaining units. The current law nondiscrimination rules make a dramatic departure from established policy, in that they require employers to count the benefits provided to union-represented workers through multiemployer plans in testing whether their other benefits are discriminatory. The NCCMP believes this approach is wrong as a matter of principle. We believe employers and unions should be free to bargain in good faith on behalf of one group of employees without affecting the pay or benefits of others working for the company.

A. Multiemployer Plan Valuation Rules

We are also encouraged to see that the Bill includes the special rule of current law permitting an employer to treat the contributions it makes to a multiemployer plan on behalf of an employee as the employer-provided benefit of such employee under the plan. As we understand it, an employer would be treated as providing coverage to (and only to) the employees with respect to whom it actually made contributions. The value of that coverage for a testing year would be the hourly rate of the contributions paid on the testing day, computed on an annualized basis. Multiemployer plan participants with respect to whom an employer does not make contributions are treated as not covered. These include, for example, retirees and former employees.

This rule is crucial to workable section 89 testing of multiemployer plan benefits. As discussed above, the plans and the contributing employers are completely independent of one another. Typically, an employer's involvement with a multiemployer plan begins and ends with the periodic payment of the contributions required by the collective bargaining agreement. The plans' labor-management boards of trustees establish the plan of benefits. They determine eligibility and coverage rules, financing, etc. Most employers, other than those on the boards of trustees, are not well informed about the details of the specific benefits the multiemployer plans provide, or even which of the employees with respect to whom they contribute are actually covered under the plan. Indeed, they would have no need for that specific information in running their business.

An employer that is aware of all of the details of the specific coverage rules and benefits of a multiemployer plan to which it contributes would still be unable to determine which of the employees with respect to whom it contributes are actually covered. This is because, as discussed above, coverage under a multiemployer plan depends on service with all employers contributing to the plan. The specific employer for which an employee is working at the moment will not have information about that employee's service with other employers. Further, in many multiemployer plans, there are "hours banks" that permit employees who have had more hours than necessary for coverage during one period to push some of those hours forward to obtain coverage in a subsequent period during which the employee would otherwise not be covered. Again, an employee's current employer would not necessarily be aware of that employee's past service for another contributing employer that can be used for this purpose.

The special multiemployer plan rule permits employers to test for section 89 compliance based on information they have available. The only information a typical employer has is the contribution he makes per employee. It is therefore appropriate to permit such employers to test on this basis. In addition to being a workable solution, such testing, in the typical multiemployer plan, provides a good approximation of the results that would be obtained if actual coverage were tested.

B. Application of the Multiemployer Plan Valuation Rule to the Bill's Tests

We urge you to clarify that the multiemployer plan valuation rule discussed above would be applied as follows in the context of the new nondiscrimination rules included in the Bill.

1. Employer-Based Testing

First, and most importantly, we seek confirmation that the responsibility to test for compliance with the nondiscrimination requirements of section 89 would remain with each individual employer contributing to a multiemployer plan. As discussed above, plans do not have, and ordinarily cannot get, information relating to management and salary structure of employers, employees not covered by the multiemployer plan, and other plans maintained by employers, all of which is crucial to section 89 testing.

On the other hand, only the employers have access to information necessary to determine which, if any, of their employees are highly compensated. Contributing employers have information about the other plans they maintain. They will prepare the Forms W-2 for their employees and are therefore the appropriate parties to determine section 89 compliance and, if necessary, to include additional amounts in employee income for purposes of FICA and federal income tax. Finally, thanks to the multiemployer plan valuation rules described above, the employers have information, in the form of required contributions, necessary to value the coverage provided under multiemployer plans to which they contribute.

2. The Testing Process

a. A Bargaining Unit That Includes No Highly Compensated Employees Automatically Passes the Tests

Each employer would proceed to test as follows: The employer would determine, based only on compensation paid by that employer (without reference to compensation paid to any of its employees during the year by any other employer, regardless of whether or not such other employer contributes to the same plan), which of its employees in a particular collective bargaining unit are highly compensated. If there are no highly compensated employees in the collective bargaining unit being tested, the section 89 requirements are satisfied with respect to that bargaining unit.

b. Bargaining Units Including Highly Compensated Employees

If there are one or more highly compensated employees in the collective bargaining unit, the employer will then have to pass the following three tests.

(1) The employer is required to make contributions for at least 90 percent of the nonhighly compensated employees in the collective bargaining unit, other than excludable employees.

(a) For this purpose, the determination of which employees are excludable should be made separately for different bargaining units and for the nonbargained group. Thus, for example, the fact that a multiemployer plan has no minimum service requirement should not affect the excludability of short service employees under other plans maintained by the employer and vice versa. Under current law, multiemployer plan eligibility rules do no affect employers' exclusions. It should be made clear that separate testing for union-represented employees under H.R. 1864 leads to the same result.

(b) In addition, for this purpose, a determination of whether an individual is excludable as a part-time worker should be made on the basis of annualized hours or other equivalencies. Thus, for example, if an employee did not have thirteen hundred hours of service (25 hours times 52 weeks per year) during a testing year, that employee would be excludable as a part-time worker. If plan eligibility is measured on a monthly basis, 100 hours would be the equivalent exclusion threshold.

(2) The plan does not require either pre- or post-tax employee contributions above the levels specified in the Bill for any active employees (excluding contributions for COBRA coverage). An employer should be deemed to satisfy this requirement if it obtains written assurance from the plan that no such contributions are required. We note that it would be useful to make it clear, in legislative history or statutory language, that COBRA contributions are not relevant.

(3) The employer must not pay an hourly contribution rate for any highly compensated employee in the collective bargaining unit that is more than 133 percent of the highest contribution rate paid by the employer for 90 percent of the nonhighly compensated employees in the collective bargaining unit.

Note that the special rules for multiemployer plans discussed above require the employer contributions to be adjusted, for purposes of section 89 testing, if the allocation of plan benefits between highly compensated employees and other employees under a multiemployer plan varies materially from the allocation of employer contributions to such plan. This adjustment will provide a basis for necessary adjustments for entertainment and a few other industries where employer contributions are set at a percentage of pay, rather than on a cents-per-hour or similar basis, but coverage is nevertheless uniform. Thus, in these few special situations, employer contributions provide a grossly exaggerated estimate of the value of coverage provided to highly compensated employees.

If the contributions the employer makes with respect to employees in a collective bargaining unit pass all three of the tests described above, no additional amount will be included in the income of any highly compensated employee of the employer.

We believe that, if interpreted and implemented as described above, the Bill would provide appropriate and workable rules for testing coverage under multiemployer plans for compliance with section 89. We are confident that virtually all multiemployer plan coverage will comply with the new rules on this basis. The problems our plans have had with the section 89 rules do not arise due to any discrimination or abuse within the plans. These plans are not discriminatory. The vast majority of their participants are rank-and-file union workers, who are not highly compensated and the benefits for those in each bargaining unit are uniform. The problem, instead, has been the enormous, and, in some cases, virtually impossible, burden of testing this coverage to prove that it is, in fact, nondiscriminatory.

3. Definition of "Professionals"

Under the Bill, the special multiemployer plan valuation rule described above would not apply to any employer maintaining a multiemployer plan "if such employer makes contributions to such plan on behalf of any individual performing services in the field of health, law, engineering, architecture, accounting, actuarial science, financial services, or consulting or in such other fields as the secretary may prescribe." Similarly, separate testing of bargaining units would not apply to a bargaining unit more than a de minimus number of the employees in which "perform services in the field of health, law, engineering, architecture, accounting, actuarial science, financial services, or consulting or in such other fields as the secretary may prescribe."

This language, however, could be construed to include a far broader group of individuals than the professionals it is intended to define. For example, orderlies, nursing assistants, and other nonhighly paid individuals perform services in the health field. Unions, plans, and some contributing employers may employ staff attorneys who are not highly paid, but who perform services in the field of law.

Accordingly, we suggest that the intent of this provision would be better served if the group were defined as follows:

> "professional employees who on any day of the plan year perform professional services for the employer as a certified or other public accountant, actuary, architect, attorney, chiropodist, chiropractor, investment banker, medical doctor, dentist, optometrist, osteopath, podiatrist, engineer, psychologist, stockbroker, veterinarian or in such other professional capacity determined by the secretary."

Similar language has been proposed by the Department of the Treasury to implement nondiscrimination provisions for pension benefit plans.

In addition, we suggest that this group be limited to individuals who are highly compensated within the meaning of Code section 414(q). This will achieve the desired result of preventing discrimination in favor of highly paid professionals, while making this needed relief available to other groups.

We also suggest that, for purposes of both the special multiemployer plan valuation rule and the separate testing rule, the "professional" rule be applied on a bargaining agreement by bargaining agreement basis. Thus, the denial of the special rule to a bargaining agreement that includes professionals would not preclude the employer's use of the special rule with respect to other bargaining agreements covered under the same multiemployer plan, if such other agreements did not cover professionals.

Finally, we suggest that, for purposes of both the special multiemployer plan evaluation rule and the separate testing rule, a two percent de minimis rule should apply for purposes of the "professional" rules. Thus, if not more than two percent of the employees in a bargaining unit are "professionals", the bargaining unit should be treated as not covering professionals and the special valuation and separate testing rules should be available with respect to that unit. This is included in the bill's provision for separate testing for union-represented employees, and in proposed Treasury regulations for pension plans.

III. ELECTIVE COMBINED TESTING

As noted above, we believe that separate testing of collective bargaining units is appropriate, both because of the special considerations that apply to a collective bargaining situation and because of the practical problems that arise in testing multiemployer and single employer plan coverage on a combined basis.

Nevertheless, many employers provide substantial and valuable health coverage to nonhighly compensated employees under multiemployer plans. It seems inequitable to permit employers who provide valuable health coverage to their salaried nonhighly compensated employees in a nonbargained situation to take credit for that coverage when testing the coverage they provide to their highly compensated employees, but to deny employers who provide coverage to their nonhighly compensated employees through the collective bargaining process the same opportunity.

In many, if not most, cases, this opportunity would not be available, as a practical matter, to employers contributing to multiemployer plans, simply because the burden of combined testing is too great. However, there may be some employers that would find combined testing, using the multiemployer plan valuation rules described above, reasonably workable, and that need to count this coverage to help their other plans pass the nondiscrimination tests.

We, therefore support the position taken by other groups that such employers shall be permitted (but not required) to elect to test their collective bargaining unit employees and their other employees on a combined basis.

IV. QUALIFICATION REQUIREMENTS

We also urge you to consider exempting multiemployer plans from the qualification requirements of Code section 89(k). In addition to ERISA, which provides most of the same participant protections as section 89(k), all multiemployer plans must meet comparable standards under section 302(c)(5) of the Taft-Hartley Act.

These plans are required under the Taft-Hartley Act to be in writing. In addition, under Taft-Hartley, there are protections to prevent the diversion of funds to purposes other than the benefit of employees. These plans, by definition, are maintained pursuant to collective bargaining agreements, which are legally enforceable, and employees may sue to enforce their Taft-Hartley protections directly. The minuscule percentage of employees covered under multiemployer plans who are not covered pursuant to collective bargaining agreements are covered pursuant to participation agreements, which are also legally enforceable. Collective bargaining agreements typically run at least three and often more years. Thus, the plans to which contributions are made pursuant to such agreements will be in effect for at least the one year required to satisfy the permanence requirement of section 89(k). Finally, these plans are subject to Title 1 of ERISA, which requires summary plan descriptions and other types of notice to participants. The unions, which bargain these plans, are also anxious to make certain that the employees are aware of the benefits that have been bargained.

The protections described above likely will not fit exactly all of the technical requirements of Code section 89(k). However, taken together and added to ERISA, they provide several layers of similar and adequate protections. It is therefore not necessary to impose on multiemployer plans and the employers contributing to such plans the burdens of compliance with Code section 89(k).

We therefore urge you to exempt multiemployer plans from the qualification requirements. These requirements are largely redundant in the context of multiemployer plans, which are subject to several other laws designed to achieve a similar purpose. In addition, because of the unique nature of multiemployer plans, the rules would be unworkable and would create inequitable and unnecessary burdens.

* * *

If you have any questions, or if we can be of further assistance, please call Vivian H. Berzinski (872-8610) of our professional staff.

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May 12, 1989

The Honorable Dan Rostenkowski
U.S. House of Representatives
Chairman, House Ways & Means Committee
1102 Longworth House Office Building
Washington, D. C. 20515

BY HAND

Dear Mr. Chairman:

We appreciate this opportunity to submit a statement for the record relating to H.R. 1864. This is a combined submission by the National Forest Products Association (NFPA), the American Paper Institute (API), and the American Pulpwood Association (APA).

NFPA represents the wood products segment of the industry; API represents paper, paperboard and wood pulp manufacturers; and APA represents wood pulp manufacturers and logging contractors.

The industry endorses the objectives of H.R. 1864, and appreciates the relative simplicity of this approach to the nondiscrimination requirements of the law. H.R. 1864 represents an important step in assuring that employee benefits are provided in a nondiscriminatory manner under rules that employers can understand and effectively implement.

While the industry believes that additional changes are needed before the bill can successfully accomplish these objectives, we are particularly concerned with the issue of independent contractors and their employees. This concern is based on our belief that both the proposed leased employee regulations and H.R. 1864 appear to treat as leased employees many individuals whom Congress never intended to be included as employees of the company receiving their services.

We therefore urge the Committee to delay the effective date for dealing with leased employees in Section 89 in order to give the Treasury Department time to develop alternative rules for leased employees. We are prepared to work closely with the Treasury Department to provide a definition of a leased employee which will preclude the type of abuse that we believe Section 414(n) was intended to address, but which will not discourage the establishment and maintenance of broad based employee benefit programs. Our recommendation includes a delay in implementation of the safe harbor for leased employees, because the inclusion of this safe harbor does not resolve our concerns over the definitional problem.

In defining a leased employee, our industry suggests that one test that could be considered is the day-to-day supervision of the employee. For example, in a typical leased employee case, the leasing organization furnishes one or more of its common law employees to the lessee company, and the lessee supervises the leased employee's activities. However, when a principal contracts with a bona fide independent contractor, the contractor agrees to perform services but retains the right to, and in fact, determines how those services are performed. Moreover, the contractor retains the right to supervise his own employees in every aspect of their work in performance of the contract. If such a test were adopted, to guard against situations in which there may be abuses the regulations could authorize the Commissioner to classify the workers as leased employees. However, the principal should be given the right to challenge such a determination administratively and, if necessary, in court.

The confusion and uncertainty generated by the broad reach of the regulations should be resolved as soon as possible. The threat of inappropriate and severe penalties can only be eliminated by creating a fair and realistic definition of a leased employee.

Respectfully yours,

Kenneth Rolston
Kenneth Rolston
President
American Pulpwood Association

Red Cavaney
Red Cavaney
President
American Paper Institute

Barry Cullen
Barry Cullen
President
National Forest Products Association

Statement of

Thomas K. Zaucha
President and CEO

National Grocers Association

to

The House Ways and Means Committee
on Section 89 of The Internal Revenue Code
Tax Reform Act of 1986

The National Grocers Association (N.G.A.) appreciates this opportunity to express its views on the economic burdens from the potential improvements to Section 89 of the Internal Revenue Code which requires nondiscriminatory employer treatment between highly and nonhighly compensated employees enrolled in their health insurance and/or life insurance programs. The National Grocers Association represents 2,300 retail grocers and food wholesalers in the independent sector of the food distribution industry. Our retail grocers own and operate convenience stores and supermarkets in every state in the union, while association food wholesalers operate food distribution centers which serve these retailers. N.G.A. members have been adversely affected in a direct and substantial manner by the administrative burdens and regulatory requirements imposed by Section 89.

For the last eighteen months, N.G.A. members have wrestled with the complexity, costs and administrative entanglements of this section. Despite the fact that the statutory requirements of Section 89 created a patchwork of qualification standards, eligibility tests, benefit tests, exclusions and other provisions, which are unclear, conflicting and confusing, N.G.A. members have attempted to use their best efforts to comply. In so doing they have been handcuffed by this regulatory nightmare and swamped by the data collection and administrative costs necessary to even initially assess the application of this section. Moreover, the failure of the IRS to issue timely guidelines and regulations until March of 1989 has substantially complicated this matter. In fact, the 50 pages of these long awaited regulations, which recently appeared in the Federal Register, only served to further complicate the situation by creating even more complexity, confusion and cost.

While exact estimates of the added costs imposed by Section 89 record keeping, data collection and testing requirements are impossible due to their lack of clarity, well documented figures put the final amount of compliance expenses at somewhere between $1 and $5 billion! Charges such as these simply cannot be borne by hundreds of food retailers and wholesalers, thousands of other small businesses, and even a number of larger corporations.

Thus far the only reasonable political position for such enterprises has been to support the direct repeal of Section 89. A measure of their effectiveness can be seen in the 300 announced Congressional cosponsors for H.R. 634, a bill designed to achieve this end. On April 13, 1989, a new and potentially critical legislative development was produced by the introduction by Representative Rostenkowski of H.R. 1864. The Chairman's approach seeks not the repeal of the offending section but rather its replacement with a less onerous and complex standard.

The National Grocers Association wishes to make its position on the various legislative options available a clear one. First, if the choice is Section 89 or its functional equivalent compared with the previous system, there can be no question. Section 89 must be promptly and totally repealed. Second, to the extent that replacements for Section 89, such as H.R. 1864, are advanced, it is imperative that these meet a series of "bottom line" standards of reasonability and workability before they can be acceptable to the American small business community. Utilizing H.R. 1864 as a model, N.G.A. would suggest the following areas of improvement as clear indications of standards we believe to be essential:

(1) Part-time Employees. H.R. 1864 sets the exclusion for part-time employees at 25 hours. While this is an improvement over the current Section 89 requirement of 17 1/2 hours, it still fails to reflect either typical employment practices or exclusionary provisions of most health insurance policies.

In order to maintain adequate service levels, the operations of retail grocers and food wholesalers are necessarily highly labor intensive. Since the customer demand for service varies from both the time of day and the day of week, part-time employment is absolutely necessary to maintain adequate customer service levels. Normal practice in the food *retailing industry is to classify those employees who work less than 30-*32 hours per week as part-time. Such a practice is commonplace in thousands of other small business enterprises engaged in countless other consumer oriented service operations. This classification level also corresponds with the typical health insurance policy exclusion for part-time employees of approximately 30 hours per week.

Thus it is economically essential for retail grocers, convenience store operators, food wholesalers and numerous other consumer oriented enterprises that the exclusion for part-time employees be raised from 25 hours to at least 30 hours per week.

(2) Eligibility Standard. H.R. 1864 would impose a new eligibility standard for health insurance plans requiring employers to have at least 90 percent of their employees eligible for participation in the plan. It would also limit required employee contributions to a maximum of $10 per week for single and $25 a week for family coverage.

Unfortunately, the 90 percent eligibility requirement sets too high an employer standard by creating a major arbitrary threshold which fails to reflect workable and achievable compliance conditions. For smaller employers such an eligibility requirement might mean the nonqualification of only one or two employees. For larger employers, the proportional impact would be very much the same. A lower percentage eligibility standard similar to that imposed by the pension requirements of 70 percent would set a more reasonable standard for workable compliance.

The maximum employee contributions of $10 per week for individual coverage and $25 per week for family coverage set an unreasonable dollar limitation. Many employers set employee contribution levels based upon percentages, such as a 25 percent or 50 percent or more share of the health care insurance premium. A fixed dollar amount requirement such as that set out in H.R. 1864 equals quite simply a direct shifting of a major cost of health insurance to the employer. It would certainly be more fair and economically realistic to require that employee contributions be permitted on the basis of a flexible percentage rather than a fixed dollar amount.

In addition, the current proposal for indexing the fixed dollar amounts for employee contributions is deficient. H.R. 1864 would index the dollar amounts based upon increases in the Social Security Act wage index. However, examination of the more relevant data reveal that recent increases in health insurance premiums and health care costs have reached into substantial double digits, often annually exceeding 50 percent or more. Given the very likely continuation of such trends, it would be but a short time before the proposed relatively fixed dollar amount of employee contributions would approach a meaningless condition. Therefore, any index selected should base its increases upon those actually occurring in health insurance premiums and/or medical care costs.

(3) Benefits Test. A critical difference in the 133 percent test found in H.R. 1864 and the comparable test found in Section 89 can be found in the method of comparison. While Section 89 compares the average level of benefits of those employees in the non-highly compensated category against average for the highly compensated employee category, H.R. 1864 would compare the lowest level of benefits received by an individual employee against the highly compensated category. Frankly, N.G.A. sees neither comparability standard as acceptable. Certainly, that which focuses upon the lowest individual level is an extremely harsh and unreasonable test, one which would impose a costly and artificial standard of "equality." Even utilization of an "average" benefit figure within a given category imposes upon many smaller business enterprises a substantial accounting cost. A less costly procedure would be desirable.

(4) Effective Date. H.R. 1864 proposes that upon the date of enactment individual business enterprises will have the option of utilizing those tests of compliance found in present legislation or those set out in their final form in the revised legislation. The rationale for such an approach is found in its "fairness" and desire not to burden businesses which have chosen to attempt compliance under the requirements of the current system. There is no question that the thrust of this idea is a commendable one. But to translate its principle into realistic practice N.G.A. would suggest that an effective compliance date be set at January 1, 1990 or 90 days after the date of final legislative enactment, whichever is the more distant date. Upon such a date the alternative method of compliance would be available. This would permit individual employers to have full and meaningful knowledge of the actual requirements of any revision legislation rather than merely being able to guess at them in alterations of their business practices.

The four areas discussed previously do not constitute a complete assessment of the areas requiring attention and alteration in order to shape a finally reasonable "revised" substitute for Section 89. Other areas such as multi-employer plans, and line of business also must be meaningfully addressed. It cannot be stressed too strongly that absent reasonable and constructive revisions in all of these areas, Section 89 must be quickly and decisively repealed. The rhetoric of "revision" cannot be allowed to obscure the substantial burdens which this Section imposes upon thousands of small businesses throughout the nation. Only if and when the reality of revised legislation actually takes shape can it become a meaningful alternative to vitally needed repeal.

STATEMENT OF THE NATIONAL SCHOOL BOARDS ASSOCIATION

I. PASSAGE OF H.R. 1864 WOULD SIGNIFICANTLY REDUCE THE COMPLEX BURDEN COMPLIANCE WITH SECTION 89 HAS POSED FOR LOCAL PUBLIC SCHOOL DISTRICTS.

NSBA commends the Chairman for introudction of H.R. 1864. In many respects, NSBA believes that passage of H.R. 1864 would significantly reduce the complex burden compliance with section 89 has posed for local public school districts. This is so for the following reasons:

1. Current section 89 nondiscrimination rules would be replaced by a single simplified test. NSBA believes that the simplified test will enable many school districts to perform the testing "in house," thereby eliminating the need for districts to use scarce resources to pay the cost of private consultants.

2. Discrimination would be predicated on plan availability, rather than plan participation. The majority of local public school districts make health benefit plans available to their employees, but do not necessarily require their participation in the plan. Because that is so, NSBA believes that this provision will ensure that a school district health benefit plan does not fail on the basis of employee choice to forego participation in the employer-provided plan.

3. School districts which currently have no highly compensated employee would not be required to artificially create such an employee. This provision would benefit many small school districts which neither have a "highly compensated employee," nor a person on staff who is qualified to assume responsibility for performing the many activities required of a school district to comply with section 89.

4. The definition of part-time employee would be amended to include those employees who normally work 25 (rather than 17.5) hours per week. NSBA believes that this provision is particularly helpful to school districts which routinely employee individuals for greater than 17.5, but less than 25 hours per week.

5. Union plans would be tested separately from non-union plans. NSBA believes that this rule will enhance the ability of union plans to pass nondiscrimination test.

However, although NSBA believes that H.R. 1864 represents a significant improvement over present law, we also believe that the legislation is not responsive to several issues of continuing concern to local school board members and the public school districts which they serve.

II. THE EXCLUSION OF A PLAN MAINTAINED BY A CHURCH ELEMENTARY OR SECONDARY SCHOOL FROM THE DEFINITION OF "HEALTH PLAN" SHOULD BE AMENDED TO EXTEND SIMILAR TREATMENT TO A PLAN MAINTAINED BY A LOCAL PUBLIC SCHOOL DISTRICT.

Section 89 was originally enacted as part of the Tax Reform Act of 1986 (TRA). Under that Act, no employer was exempt from section 89 compliance.1/ Because that was so, the inequity which would result from a provision which exempted some, but not all, benefit plans maintained by similarily situated employers was

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1/ Section 89 did not amend section 134 which exempts the benefits of U.S. uniformed military personnel from taxable income.

originally not an issue. However, for local public school districts, that issue is raised by provisions contained in both the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and H.R. 1864.

TAMRA exempted benefit plans maintained by a church, for church personnel, from compliance with the section 89 nondiscrimination rules (section 6051(a)). For the purpose of that provision, the definition of "church" includes an "...elementary or secondary school which is controlled, operated or principally supported by a church or by a convention or association of churches" (26 U.S.C. 3121(w)(3)(A)). H.R. 1864 would continue to exempt church elementary and secondary schools from compliance with section 89 (section 89(e)(1)). The health plans maintained by local public school districts are not afforded the tax favorable treatment extended to church schools under TAMRA or H.R. 1864.

While it is true that certain course offerings may distinguish the curriculum of a church school from a public school, from a public policy perspective these institutions share a common function and purpose. That is, the education of the nation's youth.

Because State law imposes requirements on all accredited elementary and secondary schools, the unique personnel requirements of these institutions obtains without regard to the fact that they are controlled, operated, or supported by the public through a local school board, or a church. That is, all elementary and secondary schools must compete for professional staff from the same limited pool of qualified teachers, principles, and administrators. In general, the budgetary constraints under which all schools operate preclude school employees from receiving salaries equivalent to those individuals with similar education and background command from private industry. Because that is so, in an effort to retain and attract competent personnel, both public and church schools have uniformly been driven to enrich the benefit package available to their employees.

In enacting the TRA, Congress determined that the substantial Federal cost related to employer-provided health insurance coverage is justified only if the tax benefits fulfill important public policy objectives. In that regard, NSBA believes that an important public policy objective - education of the nation's youth by competent personnel - is a public policy objective of the highest order, and that it would be furthered by excluding all school health benefit plans from the section 89 definition of the term "health plan." Alternatively, NSBA also believes that this objective is significantly undermined when such an exclusion applies to health plans maintained by church schools, but does not extend to local public schools (which serve no purpose other than a secular, public purpose).

III. THE EMPLOYER-PROVIDED BENEFIT UNDER A SALARY REDUCTION ARRANGEMENT SHOULD CONSIDERED TO BE NO LESS THAN THE VALUE OF THE TAX SAVINGS AVAILABLE TO A RANK AND FILE EMPLOYEE UNDER THE RICHEST COMBINATION OF HEALTH BENEFIT OPTIONS AVAILABLE UNDER THE PLAN.

Over the past decade, many local public school districts made benefits available to their employees under cafeteria plans. In large measure, local public school districts moved to cafeteria plans in response to employee demands for flexibility in choosing benefits based on the unique needs of the employee and their family.

The annual battle over school district employee salaries and benefit levels has traditionally been the focus of public debate and media coverage. In many districts, taxpayers have increasingly voiced objection to the fact that when employer-provided benefits are not reflected in employee salary, the public has no way of ascertaining the actual compensation of individual school district personnel.

In response to the demand of both employees and taxpayers, many school districts instituted a cafeteria plan which allowed for employee "choice" in benefits. At the same time, districts increased (across-the-board) the compensation levels of employees, thereby assuring that the value of the employer benefit was reflected in publicly recorded salary levels.

Should H.R. 1864 be enacted in its current form, school districts which were responsive to employee needs and the public's right to know (by making salary reduction arrangements available to their employees) would be penalized. Moreover, because the bill would often require employers to restructure their cafeteria plan to provide "core coverage" (which may never be the choice of any employee), many benefits which both highly compensated and rank-and-file employees need and want may no longer be available.

NSBA believes that the Committee did not intend for employees to be penalized by passage of H.R. 1864. Rather, the intent of the legislation is to ensure that (at a minimum) rank-and-file employees may receive health benefits which are not disproportionately lower (e.g., cost to the employee and value of the benefit) than those available to highly compensated employees. In that regard, the tax favorable benefit of such plans to any employee is not reflected by the premium cost for health care coverage, but rather by the tax savings achieved by the salary reduction.

Because that is so, NSBA urges the Committee to adopt a special rule for determining the employer-provided benefit under salary reduction arrangements when they are made available to all employees (other than those who are excluded from consideration under section 89) on the same basis and in the same dollar amount. Under the special rule, the employer-provided benefit would equal an amount no less than the than the tax savings which would be achieved by a rank-and-file employee if he participated in the richest health benefit options available under the plan.

NSBA believes that such a rule would continue to encourage employees to fully participate in the health benefits available under cafeteria plans, while ensuring that the tax savings to a highly compensated employee does not exceed that available to a rank-and-file employee.

IV. A DETERMINATION OF THE EXCESS BENEFIT OF A HIGHLY COMPENSATED EMPLOYEE IS MORE APPROPRIATELY DETERMINED ON THE BASIS OF HOUSEHOLD INCOME, RATHER THAN THE STATUS OF AN INDIVIDUAL EMPLOYEE.

Congress has stated that the original purpose of section 89 was to increase health coverage among rank-and-file employees (and their families) who otherwise would not purchase or could not afford such coverage. In that regard, both present law and H.R. 1864 presume that all highly compensated employees can afford such coverage. However, that is not necessarily the case. In fact, based on household income, rank-and-file employees may often be positioned to afford a richer health care plan than highly compensated employees.

For example, under present law and H.R. 1864 an employee is considered "highly compensated" when they receive compensation in excess of $50,000 per year and are in the top-paid group of employees for such year. That determination is made without regard to the fact that the highly compensated employee may be a single parent, and/or the sole source of household income. Alternatively, the household income of a couple, both of whom are considered rank-and-file employees, may actually exceed $100,000 per year (assuming each earns a salary of $50,000 per year and when neither spouse was in the top-paid group of employees for such year).

In the example, the employer would be required to include any excess benefit amount in the taxable income of the highly compensated employee, without regard to the household income level. Alternatively (and despite the fact that the household income level is substantially greater than that of the "highly compensated" employee), no excess benefit amount would be included in the taxable income of the dual income rank-and-file employee household.

NSBA believes that the Committee should recognize the inequity which may result under the current definition of highly compensated employee when that individual is the sole source of income for their household. Therefore, NSBA further urges the Committee to extend to those individuals a tax credit equal to the value of their excess benefit.

V. CONCLUSION

NSBA believes that passage of H.R. 1864 would significantly reduce the current burden imposed on employers who are attempting to comply with the complex requirements of section 89.

However, NSBA urges the Committee to adopt the following improvements to H.R. 1864:

Amend the definition of "health plan" to provide that such term shall not include a plan maintained by a local public school district.

> Adopt a special rule governing salary reduction arrangements which provides that the employer-provided benefit shall be no less than the value of the tax savings achieved by a rank and file employee under the richest combination of health benefit options available under the plan.

Provide a tax credit equal to the amount of excess benefit included in the income of a highly compensated employees when such employee is the sole wage earner in their household.

NSWMA
National Solid Wastes Management Association

April 25, 1989

Honorable Dan Rostenkowski
United States House of Representatives
Washington, D.C. 20515-1308

Re: H.R. 1864 (Simplification of Section 89, Internal Revenue Code, Employee Benefit Rules)

Dear Representative Rostenkowski:

On behalf of the National Solid Wastes Management Association (NSWMA), I commend you for introducing H.R. 1864, a bill which would significantly simplify Section 89 of the Tax Code relating to employee benefit plans. NSWMA's membership consists of over 2,500 companies providing necessary services in the areas of solid, infectious, and hazardous waste collection, treatment, and disposal. Many of NSWMA's members have already been directly and adversely impacted by the extremely complex, burdensome, and costly requirements imposed by current Section 89. One NSWMA member, a small business concern, estimates that it will be forced to expend over $25,000 in legal and consulting fees in order to assure compliance. In fact, unless Section 89 is considerably streamlined, many employers will have no choice but to discontinue voluntary employee benefit plans. NSWMA fully supports your efforts to simplify Section 89 by substituting reasonable and understandable alternatives in order to achieve the goal of assuring fair distribution of employee benefits.

The interpretive regulations recently released by the Internal Revenue Service have not corrected, and cannot correct, the problems associated with present Section 89. The extreme complexity of the benefit testing requirements, and the costly administrative burdens imposed by the Section, make compliance with the Act almost impossible. Instead of promoting employee benefit plans, Section 89 serves as a disincentive to the expansion of current benefit plans and the implementation of new ones. At present, Section 89 benefits only tax consultants, and in the words of Senator D'Amato, leaves "employees [as] the victims of this legislation when their benefit plans are cancelled or benefits are reduced."

The goal of safeguarding plans from discriminatory activity can be advanced through less cumbersome, expensive, and confusing means. H.R. 1864 would help accomplish the true purpose of Section 89 by focusing on instances of obvious discrimination in plan design and by avoiding costly and burdensome evaluation procedures. H.R. 1864 is an important first step in the development of an approach that truly encourages the development and expansion of voluntary employee benefit plans.

Sincerely,

Eugene J. Wingerter

Eugene J. Wingerter
Executive Director/CEO

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TESTIMONY OF
THE
NATIONAL TELEPHONE COOPERATIVE ASSOCIATION
BEFORE THE
U. S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

May 29, 1989
Washington, D. C.

The National Telephone Cooperative Association (NTCA) is a national trade association representing almost 500 small, independent cooperative and commercial telephone systems serving rural customers in 42 states. On the average, our member systems provide telephone service to areas with an overall density of only 5 customers per mile of telephone line.

We would like to submit testimony regarding the impact H.R. 1864 would have on small telephone companies serving vast agricultural and rural areas.

Current Law

The National Telephone Cooperative Association would like to express our appreciation to Chairman Rostenkowski and the committee for introducing H.R. 1864. As has been stated repeatedly, Section 89 is a compliance nightmare.

It is especially burdensome for the members of our association. They are small businesses and they don't have the financial resources to hire consultants or buy computer software. None of the almost 500 small telephone systems have personnel departments and, thus, are not equipped to figure out compliance of Section 89. In rural areas it is especially difficult to find consultants who are specialists in specific areas of tax law, such as Section 89. Finally, telephone companies are very capital intensive. They need capital to ensure that their technology is kept up to date. Telephone service is a necessity, and these systems must use their resources where they are needed to maintain a modern telecommunications network for their subscribers and the rural economy. Thus, small, rural telephone companies are especially adversely affected by Section 89 because they _are_ small businesses, they _are_ capital intensive and they _are_ in high cost _rural_ areas.

Congressional Intent Regarding Section 89

NTCA supports the policy goals of expanding access to health care coverage and ensuring that coverage is non-discriminatory. Section 89, however, forces employers to spend money on statistical testing rather than on improving benefits.

As an association that represents those in rural areas, we are especially concerned with expanding health care coverage. It is clear that health care is lagging behind in many parts of rural America. It is likely that the intent of Section 89 would backfire and that many businesses, especially smaller ones, would simply drop health benefits. We would like to see Section 89 reformed while keeping the original intent of the provision.

Impact of H.R. 1864

Overall, NTCA supports the thrust of Chairman Rostenkowski's bill; however, we do have several suggestions. This bill would be a solid step forward for several reasons:

(1) The change from the current utilization-based approach to an eligibility-based test. Employers should not be penalized if an employee elects not to participate.

(2) Raising the hours for counting part-time employees is very important, especially for small businesses. A great number of our small telephone systems use part-time employees. Twenty-five hours is a much more reasonable cut-off point than 17½ hours.

NTCA feels that the design-based provision and the part-time threshold are two very important reform provisions.

Suggestions for H.R. 1864

Chairman Rostenkowski's bill would impose limits on the required employee contributions. We understand that the purpose in limiting contributions by employees is to assure coverage affordability and avoid discrimination. However, we feel that fixed-dollar amounts are not flexible enough and are impractical for small businesses, for several reasons:

(1) There is such a wide range in the cost of benefit plans and in the percentage that the employers pay. The point of the law is to prevent discrimination, not to mandate how much an employee should pay.

(2) Having a fixed dollar amount, which is relatively low, may encourage employees to elect a bare-bones health plan, when the purpose of the law is to expand coverage.

(3) Small employers often pay more for the same coverage. Compliance with the fixed dollar amount would be more difficult for small businesses.

(4) Health care costs are rising at a much faster rate than the proposed indexation of the $10 and $25 limits.

Instead of a dollar amount, we suggest that the contribution limit be based on the percentage of health care costs an employee pays for coverage. For example, we would suggest that an employee should pay no more than 35% of his total health benefit package.

The main difficulty we see with H.R. 1864 is the fixed dollar amounts. We believe that a contribution percentage is a more flexible and practical method approach.

Small Business Exemption

The fact that small employers often pay more for the same health care coverage than larger firms is a good example of why small businesses should be exempt from H.R. 1864. Almost every provision in both Section 89 and in H.R. 1864 affects small businesses differently than large ones.

Section 89 is complex and controversial and it has been difficult to fashion a workable reform bill. By exempting small businesses, H.R. 1864, will address the concerns of most groups. In the area of health benefits, large and small businesses vary so greatly that it is next to impossible to write legislation that applies to both of them fairly.

Some small business groups are against an exemption. They argue that they want to see the bill reformed and exemption is an easy out. We also want to see the bill reformed, but we believe that large and small businesses have very different problems and concerns.

Other affected groups want to see small employers be given more time for compliance. However, no amount of time will put large and small businesses on equal footing in terms of benefits.

The differences between large and small businesses have been acknowledged in other legislation. Minimum wage and parental leave legislation both take into account the impact on small business. Some of the most salient differences are:

(1) There is a bias in favor of large companies in terms of health benefit costs.

(2) Often small companies have less choices when purchasing health benefits.

(3) Strict underwriting requirements are often a problem for small businesses. For example, in a small company an uncoverable employee can disqualify an entire group from coverage.

Summary

The National Telephone Cooperative Association commends the chairman and the committee for writing a bill that reforms Section 89. It is a great step forward.

Our two main suggestions are to:

(1) Replace the allowable contribution dollar amount with a cap on the percent an employee pays, such as 35%.

(2) Include a small business exemption. The number of employees is considered when insurance is purchased and small companies are often at a disadvantage when purchasing coverage. An exemption, or at least an alternative, should take this into consideration.

We ask that the committee consider our suggestions as it continues to examine Section 89.

Comments re: HR 1864 (A Bill to Simplify Provisions of IRC Section 89)

Submitted by: Walter D. Broadnax
President, NYS Civil Service Commission
Chair of Section 89 Compliance Task
Force of the State of New York

New York State welcomes the introduction of HR 1864 and supports many of the changes it would bring about in the nondiscrimination rules of the present law. We believe that testing based on availability rather than actual usage provides a more rational basis for measuring the discriminatory aspects of benefit plans while retaining essentially valid qualification standards.

Before commenting further, we wish to make it clear that New York, as an employer, supports in principle the underlying premise of Section 89. The use by employers of tax exempt benefit plans to provide benefits which discriminate in favor of highly compensated employees is a public policy issue that must be addressed. In this respect, Section 89 holds forth some laudable objectives. It is also part of an understood social policy agenda which is targeted at increasing the availability and access to a broader array of benefits for all workers in this nation. Again, this objective is both acceptable and laudable.

Beyond our initial assessment of Section 89, which was, and remains, that it should not apply to public sector benefit plans, our concerns with the current law focused on the work load and cost impact of this statute and regulatory action by the Internal Revenue Service upon New York State and other public employers. Many of these concerns have been addressed by Representative Rostenkowski's bill, but some problems remain. They exist in three areas which we will address separately:

- Concerns caused by the specific provisions of HR 1864;
- Concerns about the current law which have not been addressed by HR 1864;
- Our strong belief that Congress should exempt public sector benefits plans from Section 89.

It is important to note that about 94% of the NYS government work force is covered by collectively bargained agreements with public employee unions, two of which represent highly compensated, professional, scientific, and technical personnel. With this in mind, we offer the following comments.

I. Specific comments on HR 1864

- HR 1864 provides for the use of the SSA average wage index to adjust the maximum permitted employee contribution annually. We feel that an index related to the cost of health care, such as the Medical Care Component of the Consumer Price Index, would be a more appropriate barometer, since the cost of providing benefits is more closely related to health care costs than to wages and "affordability" to employees should track with some reasonable percentage of the real cost of coverage.
- The ability to exclude, or prorate the benefits of, certain part-time, seasonal and other employees for testing purposes, may be helpful. Nevertheless, it is a problem for New York State since the categorization of these employees is on a basis which differs from current data classification, which must therefore be reorganized before those who are excludable can be identified. We do not wish

to imply that such data is not available, only that its incorporation and an assessment of whether it is useful to our compliance effort represents another distinct work load in the compliance process.

- The description of "qualified bargaining unit" excludes unions with more than a de minimus number of employees who perform certain professional services, such as attorneys, accountants, engineers, actuaries, architects. This exclusion, possibly appropriate in the private sector, is inappropriate in the public sector, where many of these professionals do, in fact, work in jobs wholly removed from the managerial, policy-making level. The organizing of professionals into negotiating units in the State work force is legitimate: some 56,000 of these professional, nonmanagerial employees are represented by the Public Employees Federation, while United University Professions represents an additional 20,000 of the employees who work in our State University system. Together these two groups comprise approximately 35% of the State's total unionized work force. The exclusion of these unions as "qualified bargaining units" for Section 89 purposes will cause them to be dealt with in a manner which is unfairly dissimilar to that of other bargaining units, for no legitimate reason.

- Also of concern is the mandate to test each bargaining unit separately. We would like this separation to be optional rather than mandatory, since we have some units which have identical, or essentially identical plans, and it would be more efficient to aggregate those groups for testing purposes.

- We are also concerned about the way in which salary reduction arrangements are categorized. For purposes of eligibility testing, such contributions are classified as "employee contribution" for both highly and nonhighly compensated employees. This is not a problem for us now, since our health plan has a premium only salary reduction plan, but it could become a factor in discouraging us from including other types of "cafeteria benefits" in future benefit packages unless we can be assured that benefits which can be exchanged for either cash or other noncore benefits, would not also be classified as "employee contribution," thereby making our aggregated plans fail the affordability tests.

- For the benefits test, a salary reduction arrangement is classified as "employer contribution" for the highly compensated but remains an "employee contribution" for the nonhighly compensated. For a nondiscriminatory premium-only salary reduction plan such as the one recently negotiated for the State's health insurance plan, this has the effect of creating an inequity and a potential testing failure where none existed before. It has the further possible effect of discouraging the State as an employer from agreeing to increase the scope of such plans for its employees, for fear of affecting our overall benefits testing results. It unfairly limits the State's ability to offer a competitive fringe benefit plan to attract and retain a high caliber work force. The detrimental effect of this disparate classification of salary reduction between highly and nonhighly compensated employees could well fall on many of our employees represented by the unions which originally negotiated the salary reduction plan, since several of them represent employees who are not managerial but are highly compensated for the purposes of this provision.

We think cafeteria plans have potential for increasing employees' control of their own benefit package, while allowing employers to better contain costs. Because the treatment of salary reduction in HR 1864 could discourage or limit future use of such plans, we would urge its elimination. If, as Representative Rostenkowski has stated, the Congress wishes to prevent an employer's evasion of the benefits test, the classifying of salary reduction as "employer contribution" should be consistent for both highly and nonhighly compensated employees for the purposes of the benefits test. We also believe that any limitations on highly compensated employee's allowable, nontaxable benefit should be related to the "average" nonhighly compensated employee's benefit rather than to the "lowest" available benefit.

- The penalty for failure to qualify benefits plans is a 34% excise tax on the employer. We think it would be more reasonable to assess such a penalty against employer contributions only. Furthermore, clarification is needed as to how this would apply to governmental agencies.

- While we welcome the delay in the applicability of Section 89 to former employees, we believe that Congress should go further and completely eliminate former employees from the scope of Section 89 testing unless a specific and different set of rules is established. Although we cannot speak for private sector situations, our benefits in New York are extended to retirees on a standard basis, established solely on service and age criteria. These criteria are uniform across all categories of employees, as is the package of benefits available to those meeting those eligibility criteria.

II. Problematic Aspects of Current Law not Addressed by HR 1864

- No additional compliance time is provided. Although we have begun the work necessary to comply, the sheer magnitude of assembling necessary data to comply with Section 89 and the current regulations of the IRS could possibly bring us beyond even the extended first qualification deadline of 10/1/89. We think it would be reasonable to provide for additional compliance time and that the clock for compliance should not be started until after IRS issues definitive regulations. We also believe that it would be difficult if not impossible for us to change any negotiated plans for any reason, including Section 89 compliance, until our next round of collective bargaining. This means if a negotiated plan fails any part of Section 89, we may be forced to keep the plan in effect (and pay penalties) until 1991. We therefore suggest that compliance deadlines for negotiated benefit plans be tied to the expiration of current agreements.

- It is unclear how some of the terms and conditions in Section 89 language apply to the public sector. For example, the concept of "a line of business" does not have any clear generally accepted meaning in State government. Each New York State agency, such as the Department of Correctional Services, the Department of Health, the Department of Motor Vehicles, has a separate and distinct mission. Do we treat each State agency, with its separate mission, as a separate line of business? We don't think so, but no application of this concept to the public sector has been provided.

  We are also concerned by the lack of clear definition for the term "employer". We have three distinct branches in the State's structure: executive, judicial and legislative. For testing purposes, it seems logical to allow governments with these structures to somehow retain identity as a single employer, applying the line of business distinctions among branches of the government while retaining the ability to test all agencies within any given branch as a single line of business. We ask that further clarification of this concept as it applies to the public sector be provided shortly.

o The importance of correcting the omissions described above becomes apparent when we look at the types of "plans" which must be qualified under Section 89. Health plans centrally administered by the Department of Civil Service on behalf of New York State currently cover some 320,000 employees and retirees of State government and their more than 700,000 dependents. In addition to the health plans, of which there are 30 currently offered, we also administer various separate dental, vision, hearing and life insurance plans, all with different participant demographics. We believe that most of these plans can be qualified with reasonable effort through reference to, and incorporation of, existing documents. However, in addition to these centrally administered plans, there are numerous other localized benefit plans available to State employees, usually as a result of collective bargaining, and also many union benefit fund-administered plans, supported by employer contributions allocated through collective bargaining. It is unclear to us which, if any, of these plans must be qualified and tested under Section 89. It is also unclear whether we must be responsible for that work, especially with regard to the union-administered benefit funds, which, although supported by employer- contributed money, are administered completely by the union benefit funds, with no employer input whatsoever. It seems unreasonable to hold an employer accountable for the qualification of such plans (and for the penalties accruing to noncompliance) when the employer has no influence over the benefits provided or the administrative practices of the union benefit fund.

o It appears that HR 1864 still permits employers to use existing measures of cost, such as COBRA, to value plans for the benefits testing. We believe that this is a valid standard, and urge Congress to eliminate the prospect of IRS-promulgated valuation tables in favor of allowing permanent use of existing cost measures to determine a plan's value.

III. Rationale for Exemption of Public Sector Employers from Section 89

o Although we support the expressed goals of Section 89, we fail to see how its application to public sector employers like the State of New York, can contribute to achievement of those goals. New York State receives no tax advantages from providing employee benefits, as is the case in the private sector. For us, offering employee benefits is a pure cost of doing business and contributes to recruiting and retention of a qualified work force. To limit our activities and creativity in those areas, when mechanisms are already in place to safeguard against discriminatory practices, contributes to an increase in the cost of government which will not translate into improved benefits for State and local government employees, nor will it result in new revenue for the Federal government. Rather, it will substantially increase our administrative expenses, which will result in ultimately producing higher premium costs being paid by public employees and public employers, all of which translates into substantial new expenses for the taxpayers of New York State.

Unlike private business, we are not able to pass the cost of compliance on to a separate cohort called "customers". Our "customers" are also our employers, and yours - the taxpayers of this State and country.

- The public sector benefit plans in New York State which must be tested under this law have origins, design and ongoing oversight which are so different from private sector benefits administration that the inequities meant to be eliminated by Section 89 are consistently absent. The authority for our programs resides in public statute and regulation. Plans are developed through collective bargaining agreements, then subjected to legislative scrutiny and oversight prior to implementation under the laws of the State. Union representation throughout the public sector work force in New York is greater than 90%. Collective bargaining agreements and long-established administrative policy uniformly require full disclosure statements and plan descriptions similar to those mandated by the Section 89 qualification standards.

  The concept of discrimination, wherein benefits are accorded to highly compensated employees on a different eligibility basis or contribution level than to nonhighly compensated employees is foreign to public sector plans; everyone, from the Governor to the entry level clerical assistant, is subject to the same eligibility requirements and contribution formulae. Therefore, to subject State public sector employers' benefit plans to criteria and testing intended to identify benefit disparities among private sector employers, is an unnecessary and extremely expensive administrative exercise.

Finally, I remind you that New York State does not have the "avoidance" option afforded to the private sector by Section 89, which is to simply report benefits provided to employees as taxable income. Private sector employers who choose this route typically increase overall compensation to employees to make good the extra tax burden which falls on them. In the public sector, "compensation" is established by collective bargaining and legislative action. We must protest Federal actions which could interfere with or influence this State management prerogative.

Thank you for your thoughtful consideration of this matter. We are available to assist you in any way we can to better understand the problems this legislation creates for New York State and other public employers within our jurisdiction. You can truly assist us by taking appropriate congressional action.

STATEMENT FOR THE RECORD
OF ROBERT W. LINN
DIRECTOR OF PERSONNEL AND LABOR RELATIONS
THE CITY OF NEW YORK
FOR A HEARING OF THE HOUSE COMMITTEE ON WAYS AND MEANS
ON H.R. 1864
MAY 2, 1989

Mr. Chairman, I am grateful for this opportunity to present the views of the City of New York to your Committee, and I am pleased that the Committee is earnestly pursuing the goal of simplifying Section 89.

Let me begin by commending you on the approach you have taken in this bill. It is a significant improvement over current law and would greatly simplify our task of trying to comply with Section 89. It is not a perfect solution for the City, but it is a good starting point for helping us with the impossible job we have under current law of testing for nondiscrimination in health benefits. The provision in your bill that would help us the most is the separate testing of collective bargaining units, although this creates other problems for us which I will discuss later.

We in New York City have some unique problems with Section 89. I would like to tell you about the benefits structure for City employees, so you can understand why we have so much difficulty complying with current law. First, we employ over 310,000 individuals in a variety of occupations -- including nurses, teachers, policemen, prison guards, laborers, and attorneys. Ninety-six percent of this workforce is represented by labor unions, which has been the case for over twenty years, and there are over 70 different labor organizations in the City. In addition, there are 135,000 retirees who receive pensions and health benefits from the City. Thus, the City is providing health benefits to almost half a million individuals, plus their dependents.

We provide a tremendous variety of health benefits to our employees because the City offers all employees a choice of up to thirteen basic health plans and then the 70 unions and the Management Benefits Fund (for all titles not in collective bargaining) adds its own package of supplemental benefits, which we fund through contributions to the welfare funds. Although the City makes a uniform health insurance contribution and has offered a uniform welfare fund contribution for each employee, the resulting contributions and benefits are anything but uniform.

Health insurance and related fringe benefits are a mandatory subject of collective bargaining in the City. All City employees are eligible to choose from the thirteen basic health plans which provide medical and hospital coverage. Seven of these thirteen plans are provided at no cost to the employee, and six require an employee contribution because their plan costs are greater than the fixed employer contribution agreed to in bargaining. Additional coverage is provided through optional benefits riders, which consist of added benefits like prescription drugs and appliances. These optional benefits are fully employee-paid and again, in each plan are available to all employees at the same cost.

Another tier of coverage is provided by the over 70 separate union-administered welfare funds and the Management Benefits Fund. An employee's eligibility for a particular benefit fund is determined by an independent board through collective bargaining certifications. This results in union welfare fund coverage for employees who are in titles certified to a union, but who are individually exempt from all collective bargaining, e.g. an office aide who works in a labor relations, budget or personnel office. The unions negotiate with the City for fixed per capita contributions for current and former members, so as to provide them with supplemental benefits such as vision, or dental benefits. The employer paid welfare contribution has generally been uniform for all groups. However, since the determination of this amount is part of collective bargaining, unions do have the right to "trade-off" wages or other benefits for higher welfare fund contributions or to divert pattern welfare fund increases to augment wages or other benefits. For example, in the 1987-90 round of bargaining, the Sanitation Union chose to forego the $150 welfare fund increase in exchange for $150 in higher wages. While we start out treating all groups alike, the results for each group may be very different.

The passage of H.R. 1864 would make it possible for us to certify that this array of health benefits is nondiscriminatory without having to do the complex testing we now have to do under Section 89. We have, however, two major concerns about H.R. 1864, and a number of questions as to how certain provisions of the bill will be interpreted that we would like to share with you.

Our first concern relates to the fact that, under the bill, "professional" unions are not considered "qualified bargaining units" for the purpose of separate testing for Section 89 compliance. This provision has been drafted too broadly -- it excludes bargaining units based on their field of work, i.e. law, health, rather than on the basis of their relationship to management. It would classify many of our unions as "professional bargaining units" because they cover health aides, staff attorneys, accountants, and other people in the fields identified in your bill. We view these as "rank and file" employees, even though they may be in "professional" lines of work, and the statutory labor scheme in New York views them similarly. I would suggest that this situation is also true of many other public sector employers, as well. If there is going to be an exclusion of "professional unions" from separate testing, we think the definition of a "professional union" should focus on owners and managers and not on every worker in the profession.

Our second major concern is that the treatment of salary reduction in H.R. 1864 would limit our ability to offer a flexible spending account or salary reduction plan providing health benefits, and we think this type of plan would be beneficial to our employees. Further, this type of plan is subject to collective bargaining and the unions negotiating with the City have demanded this plan for their members.

The difficulty that the City has with the salary reduction provision is that it treats such deductions as employer contributions for purposes of determining a highly compensated employee's employer-provided benefit. As I noted earlier, due to collective bargaining, several of our health plans require an employee contribution for basic coverage and many have an employee contribution for various riders that are open to all employees. Requiring that these premiums be paid with after-tax dollars by those highly compensated employees who will participate in the salary reduction plan would be unfair. While private sector employers have the option of "grossing up" to allow their highly compensated employees to continue to receive these benefits, in the public sector we have no such option. Instead, we would probably be forced either to reduce our health benefits for both highly compensated and non-highly compensated employees or limit or discontinue any salary reduction through a medical spending account. We believe this provision should not be included at all, but particularly when it applies to salary reduction due only to employee-paid premiums.

In addition to these concerns, we have five issues we think need to be clarified as this legislation is considered:

1) The terms "core" and "primarily core" benefits need to be defined more precisely. It is not clear to us which of the medical benefits provided through our union welfare benefit funds would be considered "primarily core" and thus part of the basic health benefit.

2) The bill needs to clarify whether or not COBRA rates can continue to be used in determining the "value" of benefits--the bill leaves the issue of valuation to the Secretary, while the Committee's description of the bill states that current law, particularly as enacted in TAMRA, will continue to apply. Since COBRA rates are already established and accepted, it is our preference to use COBRA rates.

3) There needs to be a clear definition of "former employees." Although the bill delays the application of the rules to former employees for one year, it does not clarify whom we should consider former employees or establish any guidelines on how to apply the law to this group.

4) The bill needs to clarify how collectively bargained groups are to be treated for testing purposes. We have many employees in the City who are covered under union health plans but are not voting or dues-paying members of the collective bargaining unit due to statutory restrictions on job classifications and other reasons. Are these employees included in testing the union plan or included in some other group?

5) The bill provides for a cost of living adjustment to the maximum dollar amount of employee contribution to a "qualified core health plan" which is keyed to the SSA wage index. The City believes it would be more appropriate to provide a cost of living adjustment based on the medical CPI.

In closing, I must say that there are unique circumstances in the public sector that demand special consideration, especially in those situations in which so much of the workforce is covered under collective bargaining agreements. We are mindful that you are opposed to outright exemptions for these situations; however, there are many intricacies in collectively bargained public sector benefits. In the City of New York, we do not give any one class of employees any better benefits than any other, unless a union chooses to alter the items within the bargaining package. We also give our managerial employees the same benefit package that is offered as part of the pattern settlement for all employees. Finally, in the public sector, we are open to intense public scrutiny so that any discrimination in the level of benefits would quickly be identified by one of the many constituent groups in the City.

Mr. Chairman, I applaud your efforts and the efforts of this Committee to reduce the tremendous measurement and testing burden that would otherwise fall on the City under Section 89, and I urge you to examine the issues I have raised with you today.

STATEMENT OF
OVERSEAS SHIPHOLDING GROUP, INC.
SUBMITTED TO
THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

H.R. 1864 -- Proposed Revisions to Section 89

May 12, 1989

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Introduction and Overview

This statement is submitted by Patton, Boggs & Blow on behalf of Overseas Shipholding Group, Inc. ("OSG") for inclusion in the record of the hearings of the Committee on Ways and Means (the "Committee") on H.R. 1864. That legislation would make substantial modifications to Section 89 of the Internal Revenue Code, which imposes nondiscrimination standards for health and certain other employee benefit plans. OSG is a publicly-held corporation which owns and operates the largest independent unsubsidized U.S. flag tanker fleet. That fleet consists of 12 vessels ranging in size from approximately 38,000 deadweight tons ("dwt") to 121,000 dwt, with a total carrying capacity of 914,050 dwt. Two handy-size dry bulk carriers and a pure car carriers comprise the balance of the tonnage in OSG's U.S. flag fleet, bringing the total fleet to 15 vessels aggregating 981,050 dwt and employing approximately 800 people all of whom are covered by collective bargaining agreements.

OSG is generally supportive of the basic thrust of H.R. 1864; namely, a middle ground between (1) the inordinately complex provisions of Section 89 and (2) those who advocate complete repeal of Section 89 as the preferred response to that complexity and the expense which employers must now incur simply to test for prohibited discrimination. In addition, OSG commends Chairman Rostenkowski for his decision to introduce formal legislation so that OSG and others in the private sector have specific statutory language to study and comment upon before general concepts are converted into final legislation that can be corrected or otherwise changed only by an additional act of Congress.

For the reasons explained below, OSG believes that current Section 89's provisions regarding plans maintained pursuant to collective bargaining agreements are both inappropriate and unfair. H.R. 1864 substantially cures these deficiencies. OSG urges the Committee to amend H.R. 1864 to make two clarifying changes so that represented employees generally may be excluded by an employer in applying Section 89 under the same standards as are now applied under section 410(b)(3)(A) of the Code, relating to the minimum coverage requirements applicable to qualified retirement plans.

Complexity and Compliance Costs

Section 89 was enacted by Congress as part of the Tax Reform Act of 1986 to serve the legitimate tax policy goal of assuring that benefits under tax-favored employee welfare benefit plans did not unfairly favor highly compensated employees ("HCEs"). As enacted, however, Section 89 imposes substantial burdens upon all employers. In an attempt to prevent any possible violation of the Congressional policy embodied in Section 89, the authors of the provision created three nondiscrimination tests and an alternative test, all of which are extremely complicated. Moreover, an equally complicated series of additional rules must be applied to determine when ostensibly separate plans may be, or must be, combined for purposes of the basic and alternative nondiscrimination tests. It appears that these plan aggregation rules may pose particular compliance problems when employers attempt to implement responsible medical cost containment program alternatives through flexible benefit programs, HMOs or PMOs.

The initial experiences of virtually all employers with Section 89 indicates that there is a substantial probability that private sector compliance costs are and will continue to be unnecessarily excessive even in the context of the important policy objectives Congress sought to serve when it enacted Section 89. The proposed regulations recently issued by the Treasury Department do little to reduce the complexity (and uncertainty) or ease the compliance cost encountered by all employers. For these reasons, and even if one accepts the basic Congressional policy objective, legislation such as H.R. 1864 must be enacted to replace current Section 89 with a reasonable nondiscrimination standard that is not prohibitively expensive to apply.

Represented Employees

It is widely recognized that under current Section 89 "in most cases, the employer cannot disregard employees covered by collective bargaining agreements." */ Such an approach is both a departure from the qualified plan rule (discussed below) and it is both unwise and unfair. A company should not fail the Section 89 standard merely because represented employees have been included in the non-HCE group or because the company has several separate collectively bargained health benefit plans, which differ from each other. Any contrary result--such as that which would be reached under current Section 89--would be an inappropriate intrusion into the collective bargaining process and it would impose substantial unfair hardships on a company such as OSG, which operates in a multi-union environment.

Some of OSG's represented employees are HCEs. Neither OSG nor its represented HCEs should be penalized--as occurs under current Section 89--because certain unions may choose to bargain for higher pay as compared to benefits, while other unions choose to bargain for higher benefits as compared to pay. Particularly where a union is negotiating with multiple employers--as is generally true in OSG's situation--any single employer such as

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*/ Description of H.R. 1864 Relating to Simplification of Section 89 Nondiscrimination Rules Applicable to Certain Employee Benefit Plans (JCS-9-89), page 11, April 25, 1989.

OSG may have little direct input on the benefit levels made available under such plans and such an employer will in no event be able to control the final benefit levels. Yet, current Section 89 can operate to penalize any employer and its HCEs represented by one union if another union bargains for higher current pay and more modest noncash benefits. There is no discernable policy justification for such a result.

H.R. 1864 properly recognizes that the treatment of employees subject to collective bargaining agreement must be changed. Under proposed section 89(e)(8) of the Code, the nondiscrimination standards of proposed Section 89 would be applied separately with respect to employees in each qualified bargaining unit. As defined in proposed section 89(e)(8)(B), the definition of "qualified bargaining unit" generally parallels the test for excluding represented employees in the qualified retirement plan area, as set forth in section 410(b)(3)(A) of the Code. Thus, under H.R. 1864, plans maintained by an employer pursuant to a collective bargaining agreement will be tested separately if there is evidence that health benefits were the subject of good faith bargaining. However, proposed section 89(e)(8)(B)(i) departs from section 410(b)(3)(A) in two respects. First, the former appears to contemplate that determinations as to the existence of a collective bargaining agreement will be made by the Secretary of the Treasury and not by the Secretary of Labor (as contemplated by section 410(b)(3)(A)). This appears to have been an oversight, but it should in any event be corrected so that the Secretary of Labor makes the determination under both provisions. Second, proposed section 89(e)(8)(B)(ii) requires that not more than a de minimis number of employees in the bargaining unit perform services in certain designated fields (e.g., health) or in such "other fields" as the Secretary of the Treasury may prescribe in order to be considered a "qualified bargaining unit." The reference to "other fields" should be clarified to limit its application to fields which are "similar" to those fields that are enumerated in that provision.

* * * *

To summarize, it is essential that legislation such as H.R. 1864 be enacted and that any final legislation modify the rules of current Section 89 with respect to represented employees. With the two technical, clarifying changes noted above, proposed section 89(e)(8) adequately accomplishes this objective, but it would be desirable if the relevant legislative history indicated Congress' intent that proposed section 89(e)(8) would generally be interpreted as current section 410(b)(3)(A) has been interpreted and applied.

Patton, Boggs & Blow

Paroscientific, Inc.

May 9, 1989

Robert J. Leonard
Chief Counsel
Committee on Ways and Means
U.S. House of Representative
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Press Release #14 Announcing Public Hearing on H.R. 1864, bill to simplify Section 89 nondiscrimination rules of the Internal Revenue Code by The Honorable Dan Rostenkowski (D., Ill.)

Dear Mr. Leonard:

We have received a copy of the above press release #14 from our Congressman, Rod Chandler. The H.R. 1864 does greatly simplify the nondiscrimination rules of Section 89.

We find the H.R. 1864 rules practicable with one exception:

> An affordable health plan with a maximum employee premium of $10.00 per week for individual coverage and $25.00 for family coverage. (premiums to be indexed)

The availability test could not be met by the majority of small businesses. We are fortunate in that we could just meet the proposed H.R. 1864 nondiscrimination rules for an employee, but not a family. (We consider a family - husband, wife and two children) We pay one-half of the premium for family coverage and the employee's half is $34.00.

However, we anticipate a big increase next year in our group health care premiums when we move from community rated to experience rated. One of our employee's spouse had cancer a few years ago, was determined to be in remission, and last year's examination ascertained the recurrence of cancer. The medical bills have been astronomical this year. How is an immense major medical expenditure included in the "indexed" figures, when the rates are also based on experience. The employer is providing group health care coverage for such a catastrophic use, but would be penalized under the H.R. 1864 due to experience rating by the medical insurance plans.

(continued)

Robert J. Leonard
Pg. 2, 5/9/89

The H.R. 1864 is a workable bill for the small business and the minimum premium is difficult to ascertain in order to be fair to both the employee and employer. Is the answer a look at how much insurance coverage? We provide medical health insurance to cover the catastrophic medical bills that can wipe a family out financially or should the employee have the option to have minimum coverage? Providing such a two plan option to employees would still make the premiums higher since the total employees in each plan would be reduced. Also, are rates different for various areas of the United States.

We thank all who have been so deligent in making the compliance of Section 89 more functional for all, especially the small business firm.

Sincerely,
PAROSCIENTIFIC, INC.

Deborah F Peterson

Deborah F. Peterson
Office Manager

DFP:fma

IDC Services, Inc.

MARTIN B. ROBINS
Vice President
Legal Affairs

May 10, 1989

Congressman Daniel Rostenkowski
2111 Rayburn House
Washington, D.C. 20515

RE: INTERNAL REVENUE CODE SECTION 89 REVISION

Dear Congressman Rostenkowski:

Enclosed please find a copy of comments submitted on behalf of the Powerforce Company, Inc. and Powerforce Services, Inc., subsidiaries of the undersigned corporation with respect to the regulations proposed by the Internal Revenue Service pursuant to Section 89 of the Internal Revenue Code of 1986. Although such materials were prepared in response to the formal request for comments on such proposed regulations, we suggest that the policy considerations discussed therein are at least equally relevant to the current discussion concerning revision of Section 89 itself.

The Powerforce organization is engaged in the provision of long term part-time personnel. As such, we believe that the final legislation should contain certain provisions whereby major economic benefits to society which are generated by this industry will continue to be available. We are well aware that there have been abuses of benefit provisions by certain firms engaged in the so-called "employee leasing" business. To the extent that such business is utilized in order to deny or reduce the benefits which would otherwise be available to employees we agree that governmental regulation is in order. We also agree with the premise underlying Section 89, that being an intention to broaden the scope of benefit coverage generated by a given level of tax expenditure. We simply suggest that the existing statute and regulations do not actually further the legislative objectives.

As we explain in the enclosed letter, there are certain characteristics of our operations that distinguish them from the undesirable leasing activities. Most notably, we believe that our operations actually increase total employment as opposed to merely transferring existing employees from one payroll to another. It is the existence of genuine recruiting and consulting services as part of our program which allows us to perform functions more efficiently than our clients could do for themselves and distinguishes us from employee leasing companies. In addition, it has been our experience that most of the part-time employees recruited and employed by us affirmatively desire part-time work as opposed to full-time work and/or have medical benefits available through other sources such as full-time employment elsewhere, Medicare or spousal employment. Under the circumstances, the impact of applying Section 89 is to increase the cost of our service, thus reducing the level of widely sought after, good quality part-time employment, while probably not substantially increasing benefit coverage.

We believe that the proposed criteria contained in the latter portion of our letter are useful in allowing the Internal Revenue Service and Congress to distinguish situations where the sort of regulation contemplated by Section 89 is desirable or necessary from situations where it is economically inefficient. Such criteria may logically be integrated into both the Section 89 regulations and/or final statute as well as the leased employee definition that is ultimately promulgated pursuant to Section 414(n) of the Internal Revenue Code.

While the safe harbor medical plan concept that is incorporated in your proposed revision of Section 89 is of some value, we submit that it does not address the legitimate considerations of businesses like ours, as articulated above and in the enclosed letter. In other words, to the extent that the mandatory provision of medical benefits reduces the availability of the sort of part-time employment that is in demand, it does not address the fundamental problem with the legislation.

We are prepared to consult with you and/or your staff (or the Ways and Means Committee staff) for the purpose of developing a fair, economically efficient structure for the relief requested. You and/or your staff should feel free to contact the undersigned at the phone number indicated below.

Your attention to our input is greatly appreciated.

Very truly yours,

IDC SERVICES, INC.

Martin B. Robins

MBR/nc
Enclosure

cc: David E. Allen
Donald S. Crossett

IDC Services, Inc.

MARTIN B. ROBINS
Vice President
Legal Affairs

May 5, 1989

COMMISSIONER OF INTERNAL REVENUE
Attention: CC:CORP:T:R (EE-130-86)
Washington, D.C. 20224

RE: PROPOSED SECTION 89 REGULATIONS/LEASED EMPLOYEE ISSUES

Ladies and Gentlemen:

The undersigned is Vice President - Legal Affairs and General Counsel to this Corporation and its subsidiaries, Powerforce Company, Inc. and Powerforce Services, Inc. (collectively, "Powerforce"). Powerforce is and for several years has been engaged in the business of recruiting and supplying long-term part-time personnel to major corporations in the United States, primarily, but not exclusively, for use in connection with retail merchandising programs as to which Powerforce often participates in the design. Such programs involve assisting in the sales and marketing process at the retail point of purchase by performing functions such as shelf stocking and display building as well as functioning as a liason with the retailer. The typical Powerforce client is a consumer products vendor such as a food manufacturer. Significant services are also supplied to the pharmaceutical industry with respect to provision of so-called "detail" personnel who call on doctors' offices to promote and explain ethical drugs.*

We wish to take this opportunity to express our views as to how the Internal Revenue Code Section 89 regulations impacting our segment of the part-time employment industry should be structured in order to avoid pernicious economic effects. We are doing so in response to the specific request for comments on the interplay between the employee leasing rules, such as Section 414(n) of the Internal Revenue Code and the Section 89 regulations in general which was included in the material accompanying the proposed regulations which were released on March 2, 1989.

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* We do not address the application of Internal Revenue Code Section 414(n) to the persons employed by us.

We are also aware of the legislation proposed by Congressman Rostenkowski on April 13, 1989 which contemplates a substantial overhaul of Section 89. Of greatest significance to our industry in such material is the increase in the threshold at which Section 89 would become applicable from 17-1/2 hours of work per week to 25 hours. We believe that this modification is desirable because it goes a long way towards rectifying the problems associated with existing Section 89 and the proposed regulations with respect to our line of business. However, the comments set forth below are based upon the premise that the present statute will survive without modification.

We suggest that statutory authority for the relief described below, relating solely to part-time employees, is found in Code Section 89(m):

> (m) Regulations. - The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations providing for appropriate adjustments in case of individuals not employees of the employer throughout the testing year.

Our focus is exclusively upon Section 89's nondiscrimination rules; we do not perceive the qualification standards of Section 89(k) to be a material problem. While medical benefits are of greatest significance to our analysis, other benefits to which Section 89 applies are also relevant.

Why and Where Relief is Appropriate

- Carefully Crafted Relief will Facilitate Enhancements in Employment; thus, Distinctions Among Different Types of Personnel Supply Firms must be Recognized.

We respectfully submit that it is imperative to distinguish the economic roles played by different sectors of the personnel supply industry. We recognize that one subset of this industry includes what we would term "true" leasing companies which function mainly in an administrative capacity. In particular, it is our perception that such companies generally function by causing the transfer of existing full-time employees from their client's payroll to their own payroll while causing the same employees to continue performing the same services at the same locations. The true leasing company acts as employer by assuming some of the administrative burdens associated with employer status such as physical issuance of paychecks, preparation of payroll tax returns and related tax payments, etc.

but may not offer consulting or recruiting services to its clients. Additionally, we understand that prior to the adoption of Section 414(n) of the Internal Revenue Code, such organizations were often utilized to avoid furnishing employee benefits to the workers who are transferred from one payroll to another. In some cases, such organizations permit implementation of new or improved benefit plans for persons remaining upon the leasing company's client's payroll. The most salient effect of the involvement of such companies for the purpose of this analysis is that their involvement apparently causes workers who were and would have been employed in a given capacity in any event to receive a lower level of employee benefits than would otherwise be the case.

Contrast the true leasing situation with the effects generated by Powerforce and the rest of its industry. In the case of the typical Powerforce client, there is no pre-existing staff devoted to the merchandising function. Rather, either such function is not performed at all by the manufacturers that constitute Powerforce's clients or such function constitutes a peripheral aspect of the duties of the regular full-time sales force or third party food broker representing the manufacturer. In general, Powerforce is utilized to facilitate the creation of a dedicated part-time merchandising force which is believed to benefit the manufacturer both in terms of more efficient use of its regular sales force and improved relations with retail clients. In connection with this process, Powerforce not only functions as the employer of the personnel in question but goes far beyond the function of a true leasing company in that it provides substantial consulting and recruiting expertise with respect to numerous issues of program design, initiation, maintenance and administration.

In short, the specialized nature of the Powerforce service profile is relied upon by Powerforce's clientele to permit a given function to be performed with greater efficiency than it could be performed in the absence of Powerforce. Thus, in many cases the involvement of Powerforce permits a function to be performed where in its absence it is highly questionable if such function would be performed to the same extent or at all. We submit that the net effect of the Powerforce program is an enhancement of total employment.

We submit that the Powerforce program permits the enhancement of total employment - i.e. the persons employed on a part-time basis would likely not be employed at all absent this program. As such, requiring the provision of medical benefits to such persons and/or requiring their inclusion by Powerforce clients when applying the applicable quantitative coverage standards set forth in existing Section 89 is likely to reduce total employment below the level which would exist absent such regulation. Paradoxically, the effort to encourage broad employee benefit coverage among employed persons would cause some persons not to be employed at all, let alone receive employee benefits.

Lest it be thought that the jobs created by Powerforce type companies are in some sense economically undesirable, we direct your attention to the fact that the average hourly wage rate for Powerforce employees as of March 31, 1989 was approximately $7.75. At such date, we were employing approximately 3600 persons to service 56 clients. Thus, the jobs created by us are not the transient, low level positions which are often derided by contemporary economic commentators but are true part-time career positions constituting an integral part of sales and marketing programs. In addition, the training received in our employ often facilitates progression from such positions to full-time salaried employment.

It should also be emphasized that the availability of part-time employment of the kind provided by Powerforce is independently desirable. A high proportion of Powerforce employees do not desire full time employment but do desire some employment. For example, Powerforce recruits heavily among students, retirees and parents with school age children to care for who desire to be with their children at the beginning and end of the day. As a result of their other interests and commitments, many of such persons are not generally interested in anything other than part-time employment. The relatively stable, high wage positions offered by Powerforce are well suited for their purposes. We accept the basic premise of Section 89 that meaningful health benefits should be available to primary wage earners. However, we suggest that such premise is simply not applicable in our situation. Powerforce simply does not function as an "employer of last resort" for frustrated seekers of full time employment on whom rest primary family support responsibilities.

- Section 89 Coverage is Likely to be Redundant

Even assuming that applying Section 89 to companies like ours did not reduce total employment, we respectfully submit that an independent basis for relief is the lack of necessity for the application of Section 89 in this area. As explained above, a very high proportion of the persons employed by Powerforce are not primary family wage earners. It is probable that many of such persons have medical coverage available elsewhere. For example, at least 90% of our employees at March 31, 1989 were either working a full-time job elsewhere, retired from the full-time work force, students or married. Many if not most of such persons had available medical coverage either through their other employment, Medicare, spousal employment or their educational institutions. To the extent group coverage is available at reasonable cost from such sources, there is obviously no reason for any sort of additional governmental regulation intended to facilitate broader coverage. While the proposed regulations do address this subject, we find them cumbersome and unwieldly, particularly with respect to the requirements of procuring sworn employee statements as to numerous matters such as actual receipt of such coverage. See Prop. Reg. §1.89(a) - 1(Q/A-3). It is particularly noteworthy that such regulations also require employers to ascertain the value of benefits received from other employers - a task which is difficult at best and frequently impossible.

We suggest that the unwieldly nature of these regulations will discourage many employers from even trying to utilise them, thus, bringing about the reduction in total employment described above even in situations where such result does not necessarily flow from the legislative scheme.

As a matter of recruiting policy, we recently performed an informal survey of several of the persons we employ to ascertain whether there was any interest in the provision of medical benefits. There were virtually no cases where employees expressed any interest in such coverage, at least if they would have to pay any amount out of their own pocket therefor. In general, such persons were covered elsewhere. Given our general demographic profile, we suggest that it is likely that the results of this informal survey are likely to be indicative of our employee population in general.

Specifics of the Relief Requested

Hopefully the foregoing demonstrates why Section 89 should not be applied in situations such as ours. We are taking this opportunity to set forth below criteria and mechanisms which we feel may properly be utilised by the Internal Revenue Service to identify those situations where Section 89 coverage is unnecessary and/or inappropriate. The following is merely a general outline of what we perceive a reasonable administrative framework to involve. We are quite amenable to alternative formulations intended to bring about the same result. We are certainly pleased to work with the IRS in terms of provision of input whether on a informal basis or through service on any sort of task force in order to address this matter as expeditiously as possible.

The ultimate purpose of this formulation is to limit relief only to situations where it is likely to be of significant social benefit - i.e. where it promotes total employment.

In order to permit potential clients to utilize Powerforce and similar companies in order to implement merchandising and related programs**, it is critical that they have some assurance that doing so will not create any problems for their existing benefit plans. The optimal form of such assurance is an Internal Revenue Service ruling or very explicit safe harbor. Thus, we feel that the first element of the proper administrative formulation is a ruling procedure whereby an organization wishing to utilize the services of a personnel supply firm may apply for a definitive determination by the IRS as to Section 89 applicability. In view of the necessity for dispatch in moving to implement such programs it is critical that such ruling mechanism permit the issuance of rulings on a expedited basis, preferably within 30 days following receipt of a written request therefor by the Internal Revenue Service. In order to facilitate the prompt processing of ruling requests and perhaps eliminate the need for such items in some cases, we suggest the following criteria be utilized for this purpose, perhaps even as a safe harbor in order to avoid some of the necessity of companies presenting the IRS with ruling requests:

1. The function being performed by the personnel in question should be one which has not previously been assigned to any dedicated workforce. Alternatively, it may be appropriate if a showing is made that absent the involvement of a third party vendor such as Powerforce, currently existing employment would be reduced on account of administrative burdens.

** We would not limit the relief to merchandising functions; any third party vendor supplying personnel for any purpose in accordance with the following criteria would be entitled to similar relief.

2. There must not be any diminution in actual or relative benefit levels as between the third party vendor and its client within a reasonable period of time following the involvement of the third party vendor, say, six months. In other words, the persons employed by the third party vendor must not lose their eligibility for benefits in which they would have been eligible to participate had they remained on the client's payroll and the client must not materially enhance its benefit package in a way which would have benefited such persons had they remained on its payroll. Although we recognize some difficulty in identifying diminutions in benefit levels, we suggest that the proposed benefit valuation regulations under Section 89 are likely to be of substantial assistance for this purpose.

3. In order to assure that the positions created through the involvement of companies such as Powerforce are socially desirable, we suggest that there be some minimum salary level associated with the availibility of relief from Section 89. While there is certainly substantial latitude associated with the designation of such salary level we would suggest that approximately $7.00 per hour is a reasonable threshold.

4. We suggest that as a part-time position takes on more and more attributes of a full-time position, the expectations of the employees and the reduced likelihood of availability of benefits from other sources is likely to militate in favor of coverage associated with the particular position. Accordingly, we would suggest that there be some maximum weekly hour threshold above which no relief would be available. The 25 hour per week figure proposed by Congressman Rostenkowski is a reasonable one for this purpose.

5. The employing organization must clearly perform functions other than personnel administration. Examples of such functions would be genuine consulting services with respect to matters such as program design and/or recruiting efforts being exerted in order to procure persons for the client's program as opposed to merely moving an individual from one payroll to another.

6. Where the preceding criteria are satisfied, persons employed in the specific program to which the ruling request or safe harbor analysis relates should be ignored by both the third party vendor and its client when applying Section 89. Thus it is probably necessary to promulgate regulations which allow the identification of specific programs.

We respectfully suggest that the preceding analysis and criteria supply you with a basis for exempting activities from coverage by Section 89 to the extent consistent with social needs. In that the necessary statutory authority for such action exists pursuant to Section 89(m), we believe that legitimate legislative objectives can be accommodated in such a way as to not inhibit economic growth.

We stand ready to work with the IRS in any manner requested in order to arrive at an appropriate solution. We thank you in advance for your cooperation.

Very truly yours,

IDC SERVICES, INC.

Martin B. Robins

MBR/nc

cc: Donald S. Crossett, President and
 Chief Executive Officer - IDC Services, Inc.
 David E. Allen, Executive Vice President - IDC Services, Inc.
 President - Powerforce Company, Inc.

DAVIS WRIGHT & JONES
LAW OFFICES
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(206) 622-3150

RICHARD J. BIRMINGHAM
(206) 628-7623

May 4, 1989

Daniel Rostenkowski, Chairman
House Ways & Means Committee
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: Comments on HR 1864 - Section 89

Dear Chairman Rostenkowski:

We submit the following comments as attorneys on behalf of our client Seafirst Corporation. Seafirst Corporation employs approximately 6,000 individuals in the State of Washington. Seafirst provides its employees with a competitive employee benefit package that is responsive to the desires and needs of its employees. To serve its employees, the Corporation adopted a cafeteria plan under Section 125 of the Internal Revenue Code of 1986, as amended (the "Code"). Under the terms of the plan, the employees are given credits, on a nondiscriminatory basis, to purchase the following benefits: (i) medical benefits - the employee is given an election to choose between three self-insured plans or five HMOs; (ii) dental benefits - the employee chooses between two dental plans; (iii) disability plans - the employee chooses between two long-term disability plans; (iv) life insurance - the employee may choose between 11 different insurance options; (v) reimbursement accounts - the employee may contribute to a medical or dependent care reimbursement account; and (vi) 401(k) option - remaining credits can be contributed to a Section 401(k) account on behalf of the employee. Contributions to the 401(k) account that do not exceed 6% of compensation are matched, at a 50% rate, by Seafirst Corporation.

The above-described cafeteria plan is nondiscriminatory as to eligibility. All employees of the Corporation, other than those excluded by the statutory definitions, are eligible to participate in the plan. In addition, credits to purchase benefits are allocated to employees on a nondiscriminatory basis.

The above-described cafeteria plan satisfies the eligibility test of HR 1864. Despite the fact that all options are available to all employees on a nondiscriminatory basis, the plan fails to satisfy the benefit test of HR 1864. The chief reason for the failure is the method by which HR 1864 treats salary reduction contributions. HR 1864, therefore, needs to be modified to accomodate cafeteria plans such as those maintained by Seafirst Corporation. A nondiscriminatory cafeteria plan, such as that maintained by Seafirst, should not be taxable under HR 1864. See Exhibit A for an example of how HR 1864 applies to a cafeteria plan.

Our specific comments on HR 1864 are set forth below.

1. Affordable Coverage. HR 1864 defines affordable health care coverage as core coverage for an employee that costs no more than $10 per week, or core coverage for a family that costs no more than $25 per week. The statute, however, does not provide incentives for an employer to provide non-core health coverage to employees, i.e. dental, vision, medical reimbursement and accidental death and dismemberment coverage. In order to encourage such coverage, an employer should be permitted to increase the employee cost if non-core coverage is provided. For example, if dental and vision coverage are provided, the permitted cost should be increased from $10 per week to $15 per week for employee coverage, and from $25 per week to $37 per week for family coverage. In addition, the permitted costs should be increased by an additional 10% if such coverage is provided under an HMO.

2. Clarification of the Term "Family Coverage." HR 1864 uses the terms "employee coverage" and "family coverage." However, it is typical for insurance plans to provide four coverage rates: employee coverage; employee and children coverage; employee and spouse coverage; and employee and family coverage. The statute should clarify that an employee electing any category of coverage other than "employee only" coverage is entitled to use the rules governing family coverage.

3. Benefit Test. If affordable coverage is made available to 90% of all employees, there is no need for the 133% benefit test. Therefore, the benefit test should apply only where an individual plan maintained by the employer cannot meet the eligibility test. For example, where 90% of the nonhighly compensated employees participate in one of two plans

maintained by the employer, but neither plan alone satisfies the eligibility test, the maximum highly compensated benefit should be limited to 133% of the lowest plan aggregated to meet the 90% eligibility requirement. Similarly, if the employer maintains a number of plans that meet the 90% eligibility test, and one plan that does not, the benefit under the nonqualifying plan should be limited to 133% of the highest plan that meets the eligibility test.

4. Salary Reduction Contributions. Salary reduction contributions should be considered employee contributions for purposes of the eligibility test. This treatment ensures that each employee receives affordable health care coverage. However, if the salary reduction contributions are within the affordability limits, such amounts should be considered as employer contributions for purposes of the base amount that is multiplied by 133% to obtain the limitation on benefits. Only if the affordability limits are violated should salary reduction treatments be treated as employee contributions. The current treatment of all salary reduction contributions as employee contributions means that an employer cannot provide meaningful benefits through a cafeteria plan. Because flexible benefit plans satisfy the needs of employees, Congress should be encouraging rather than discouraging these devices.

As an alternative approach, the base amount that is multiplied by 133% should be increased by 28% of the salary reduction contribution. This increase is equivalent to the benefit the employer provided by establishing a cafeteria plan to permit the benefits to be paid on a pre-tax basis rather than on a post-tax basis.

5. Medical Reimbursement Accounts. HR 1864 does not adequately deal with medical reimbursement accounts. A provision should be added that permits the average medical reimbursement account balance for highly compensated employees to be no more than 133% of the average medical reimbursement account balance for nonhighly compensated employees. Also, any rules governing medical reimbursement accounts should be effective for the first plan year beginning after December 31, 1989. Because medical reimbursement accounts contain salary reduction contributions of employees, new rules should not be applied retroactively to such employees.

6. Penalties. HR 1864 imposes the 34% excise tax on amounts "paid or incurred" under a plan, if the plan does not meet all the qualification requirements. Thus, a failure to give timely notice to even a single employee will subject the employer to a massive tax penalty. The Tax Committee should have learned a lesson from COBRA, and it should tailor the excise tax to meet the severity of the violation.

7. Delay Effective Date. Employers are now totally confused by Section 89 and its proposed revisions. The effective date of the statute should be delayed until plan years beginning after December 31, 1989.

Thank you for considering the issues raised in this letter. If we can be of any further assistance, please do not hesitate to contact us.

Very truly yours,

DAVIS WRIGHT & JONES

Richard J. Birmingham

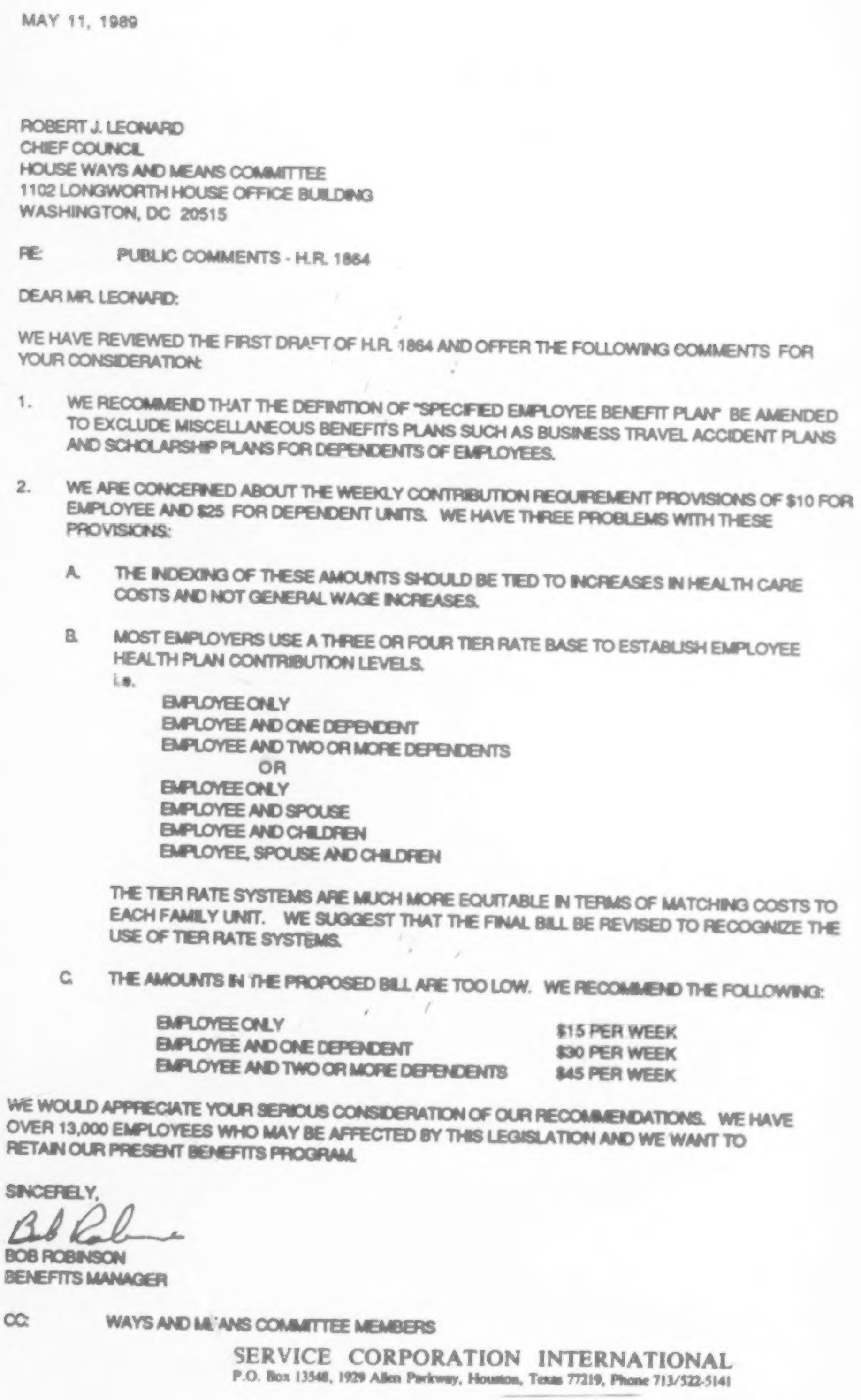
RJB:SLT
0608L
cc: Senator Slade Gorton
Congressman Rod Chandler

EXHIBIT A

Cafeteria Plan Example
(Monthly Premiums)

Plan	Cost of Employee Coverage	Employer Paid	Salary Reduction, Employee Paid	Affordable Coverage Provided	Passes 133% Test	Taxable Monthly Premium (excess above $72.68) (1.33 x 54.65)
A	76.09	54.65	21.44	Yes	No	$ 3.41
B	87.36	54.65	32.71	Yes	No	$10.68
C	83.84	54.65	29.19	Yes	No	$11.16
D	82.97	54.65	28.32	Yes	No	$10.29
E	78.45	54.65	23.80	Yes	No	$ 5.77

NOTE: Even though the cost to employees is well below the permitted charge of $43.33 per month, the employee is still taxed on the coverage. HR 1864 does not deal with cafeteria plans in a fair or rational manner. The bill must be amended to deal fairly with cafeteria plans.



MAY 11, 1989

ROBERT J. LEONARD
CHIEF COUNCIL
HOUSE WAYS AND MEANS COMMITTEE
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

RE: PUBLIC COMMENTS - H.R. 1864

DEAR MR. LEONARD:

WE HAVE REVIEWED THE FIRST DRAFT OF H.R. 1864 AND OFFER THE FOLLOWING COMMENTS FOR YOUR CONSIDERATION:

1. WE RECOMMEND THAT THE DEFINITION OF "SPECIFIED EMPLOYEE BENEFIT PLAN" BE AMENDED TO EXCLUDE MISCELLANEOUS BENEFITS PLANS SUCH AS BUSINESS TRAVEL ACCIDENT PLANS AND SCHOLARSHIP PLANS FOR DEPENDENTS OF EMPLOYEES.

2. WE ARE CONCERNED ABOUT THE WEEKLY CONTRIBUTION REQUIREMENT PROVISIONS OF $10 FOR EMPLOYEE AND $25 FOR DEPENDENT UNITS. WE HAVE THREE PROBLEMS WITH THESE PROVISIONS:

   A. THE INDEXING OF THESE AMOUNTS SHOULD BE TIED TO INCREASES IN HEALTH CARE COSTS AND NOT GENERAL WAGE INCREASES.

   B. MOST EMPLOYERS USE A THREE OR FOUR TIER RATE BASE TO ESTABLISH EMPLOYEE HEALTH PLAN CONTRIBUTION LEVELS.
   i.e.

      EMPLOYEE ONLY
      EMPLOYEE AND ONE DEPENDENT
      EMPLOYEE AND TWO OR MORE DEPENDENTS
      OR
      EMPLOYEE ONLY
      EMPLOYEE AND SPOUSE
      EMPLOYEE AND CHILDREN
      EMPLOYEE, SPOUSE AND CHILDREN

   THE TIER RATE SYSTEMS ARE MUCH MORE EQUITABLE IN TERMS OF MATCHING COSTS TO EACH FAMILY UNIT. WE SUGGEST THAT THE FINAL BILL BE REVISED TO RECOGNIZE THE USE OF TIER RATE SYSTEMS.

   C. THE AMOUNTS IN THE PROPOSED BILL ARE TOO LOW. WE RECOMMEND THE FOLLOWING:

EMPLOYEE ONLY	$15 PER WEEK
EMPLOYEE AND ONE DEPENDENT	$30 PER WEEK
EMPLOYEE AND TWO OR MORE DEPENDENTS	$45 PER WEEK

WE WOULD APPRECIATE YOUR SERIOUS CONSIDERATION OF OUR RECOMMENDATIONS. WE HAVE OVER 13,000 EMPLOYEES WHO MAY BE AFFECTED BY THIS LEGISLATION AND WE WANT TO RETAIN OUR PRESENT BENEFITS PROGRAM.

SINCERELY,

Bob Robinson
BOB ROBINSON
BENEFITS MANAGER

CC: WAYS AND MEANS COMMITTEE MEMBERS

SERVICE CORPORATION INTERNATIONAL
P.O. Box 13548, 1929 Allen Parkway, Houston, Texas 77219, Phone 713/522-5141

STATEMENT OF SHEET METAL AND AIR CONDITIONING CONTRACTORS' NATIONAL ASSOCIATION, INC. (SMACNA)

SMACNA is a national trade association representing over 5,000 contributing contractors employing well over 100,000 union sheet metal workers. SMACNA members specialize in the fields of heating, air conditioning, air pollution control, solar energy installation, architectural sheet metal and other metal applications.

HEALTH BENEFITS IN CONSTRUCTION

SMACNA members contribute on a per hour basis to multi-employer health benefit plans established under the terms of collectively bargained labor agreements. Under those agreements, employers contribute to a pooled-fund on behalf of the work force.

Multi-employer funds are jointly trusteed by equal number of representatives from labor and management, with trustees retaining control over health benefit plan design and benefit levels.

SMACNA members are aware of only the level of contribution for health benefits as agreed to in the collectively bargained agreement.

Additionally, SMACNA member firms also maintain 'in-house' single or group employer health benefit plans for supervisory or managerial employees not covered by labor agreements.

SECTION 89 AND CONSTRUCTION INDUSTRY HEALTH BENEFITS

The stated purpose of Section 89 legislation and subsequent regulations is to make health care benefits available on a nondiscriminatory basis to the maximum number of employees.

SMACNA members contribute on the average of almost $2 per hour for employee health benefits. That $2 equates to almost $3,500 on a yearly basis and that amount provides excellent health care benefits to the more than 100,000 union sheet metal workers employed by SMACNA members.

Based on information available to SMACNA regarding health benefit plans for non-represented employees, it is evident that coverage is similar if not the same as the coverage provided under the multi-employer plans.

Industries or sectors within an industry with such a factual situation should be excluded from coverage under Section 89. At a minimum, an industry or sector should be given the opportunity to petition for an exemption from Section 89 requirements.

Recognizing that superior health care benefit programs are provided to 99.9% of SMACNA member union and non-represented employees, there is an acceptable and a justifiable argument that owners and officers, those who risk their net worth with every construction project bid, are entitled to additional benefits. These small business firms have established liberal health care coverage for employees, and owners or officers should not be penalized for assuming the risks of doing business. It is that very concept of rewards or incentives that formed the foundation for the economic system under which this economy exists. Unfortunately, rewards or incentives are now being described as 'discriminatory' unless the additional benefit for risk-taking is available to those already covered by health care benefits. That description under the circumstances is unwarranted.

HR 1864

The initial version of Section 89, and recent regulations published by the IRS, are circumstances where there is no evidence of so-called discrimination. If Congress is interested or concerned with discriminatory benefit plans which are typically implemented in major corporate settings, and in certain areas such as health, law, engineering, architecture, accounting, actuarial science, financial services or consulting, then Section 89 legislation and associated regulations should be specific to firm size or the area of operation.

With specific reference to provisions of HR1864, SMACNA offers the following comments:

o Aggregation of Plans [Section 89(b)(2)(C)]

In this section there is a requirement that employers 'may elect to treat any group of 2 or more health plans as 1 plan if - (i) each of such plans is available to the same group of employees with the same eligibility requirements....' In circumstances where employer maintain one plan through a collectively bargained agreement and another for employees not represented under the terms of the agreement, it is virtually impossible for non-represented employees to be eligible for coverage under the multi-employer health benefit plans. In such circumstances, aggregation of plans is not available to SMACNA members, or for that matter any union construction contractor.

- Requirements - In General [Section 89(C)(1)]

  The 90% eligibility test should be changed to a 70% test which is consistent with pension coverage rules.

- Qualified Core Health Plan [Section 89(C)(2)]

  SMACNA also believes that the initial level of $10 to $25, and in fact any level established in federal legislation will tend to undermine cost containment programs where employees are asked to assume a portion of increased health care cost (if for no other reason than to ensure that employees monitor health care charges or fees).

- Cost of Living Adjustment [Section 89(C)(B)(A)]

  SMACNA believes that the use of an average wage index is inappropriate and that the most appropriate index is one that has relationship to health care costs which in recent years have been double digit with no sign of abatement.

- Special Rule for Multi-Employer Plans [Section 89(e)(3)(D)]

  The special rule for multi-employer plans is meaningless unless the provision on treatment of union employees applies only to single employer bargaining units. Multi-employer plans by definition cover union employees.

- Treatment of Union Employees [Section 89(e)(8)]

  SMACNA believes that HR1864 represents a step backward with the provision to prohibit employer use of plans established for union employees. This new prohibition is unrealistic and unwarranted. Adaptation or modification of plan design and benefit levels to comply with Section 89 requirements is dependent on plan control and SMACNA members as well as other union construction industry employers, will be denied the right to adapt or modify because they are sponsors and contributors to health care plans established for union employees.

  In addition and unless Congress intended to impose additional taxes on union employees, HR1864 should be modified to designate multi-employer plans covering union employees to be non-highly compensated plans. If Congress fails to make this change skilled union workers, even those not in a supervisory position, will be subject to increased income tax burdens for so-called discriminatory benefits.

  In this section, there are also provisions regarding the definition of a "qualified bargaining unit". Neither HR1864 nor the Secretary of Treasury should seek to redefine what a "qualified bargaining unit" is, since existing labor law and federal agencies have already established such criteria.

SMACNA is encouraged by the willingness of Congress to revisit this issue and urges either repeal of Section 89 or significant modifications to simplify Section 89's implementation, including an exemption where the vast majority of the employer's work force is covered by one or more multi-employer benefit plans providing health care benefits which otherwise meet other provisions of the eligibility test proposed in HR1864.

Simpson Investment Company

Testimony on Section 89 of the Internal Revenue Code
for the hearings held on May 2, 1989
by the Ways and Means Committee
of the U.S. House of Representatives

May 17, 1989

By Joseph L. Leitzinger
Vice President, Public Affairs

Simpson Investment Company is the holding company for Simpson Paper Company, Simpson Timber Company and Pacific Western Extruded Plastics Company. These companies manufacture pulp and paper products, lumber, plywood, doors and extruded PVC plastic pipe in the states of California, Michigan, Ohio, Oregon, Pennsylvania, Texas and Washington.

Background

Simpson has 8,000 U.S. employees. All employees who are hired for regular jobs (i.e., will work 90 days or more) have medical and life coverage. Benefit costs represent a higher percentage of pay for lower-paid employees than for higher-paid employees because of the cost of our medical plan (an average of $2,800 per year for 1988-89).

We have 5,500 employees who are covered by collective bargaining agreements with seven different unions. Medical plans and other benefits vary by union and by location. We have 26 medical plans, numerous HMO's and 2,100 employees who are covered by multi-employer health and welfare trusts.

Simpson has 29 work locations. Employees are paid out of one of three payroll systems. We have no common employee data base with information on all employees. Simpson does not collect all the data required to run the Section 89 test; i.e., scheduled hours of work each week, marital status, whether the employee has coverage under a spouse's medical plan, whether an employee has eligible dependents, employee relations data on independent contractors ("Kelly Services," contract janitorial workers, security guards, etc.). Costs to collect and maintain this data would be high and have no value for other purposes.

To date, Simpson has spent $50,000 in outside consulting fees, plus hours of internal staff time trying to understand the regulations and identify the data necessary to comply with them. In 1989, we expect to incur $80,000 in consulting costs to run the test, and $40,000 each year thereafter. This does not include internal computer time, nor staff resources.

A rough cut of our compliance with the test based on the data we do collect on our existing data systems, and the proposed regulations indicates that Simpson will pass the test for medical plans. We appear to fail it on the life insurance plans because collectively bargained employee groups have lower life insurance benefits than do our non-union employees. The non-union plan is based on competitive comparisons. The collectively bargained plans reflect the union desires to spend compensation dollars in medical and other areas. If we fail the test on the life insurance benefit, which requires additional taxable income to be imputed to highly-paid employees, it will generate very little added tax revenue since the value of life insurance over $50,000 is already subject to taxation under current IRS regulations (Section 79).

Conclusions

There are easier ways than Section 89 of assuring employers provide benefits to employees. A continuation of tax-favored treatment of company expenses to fund benefits is a strong incentive as are competitive pressures as employers seek to hire from a shrinking labor pool. Section 89 regulations require such a complex computer system, small businesses will in fact be discouraged from providing benefit plans to employees because of their inability to comply with this regulation.

Expending resources in the form of money and time to put in data systems which add expense, but not value, to a company's product or service make the U.S. less competitive internationally, and this is exactly what these regulations require.

Analysis of Legislation to Simplify Section 89 and of HR 1864

Section 89 is an important issue for Simpson. It places significant cost burdens on employees to understand the regulations and to identify the data necessary to comply with them, does not provide benefits to employees, and in our case generates little added tax revenue.

We have commented to Members of Congress before on Section 89 that the following actions should be taken, in order of priority:

1. Repeal the act in its entirety.
2. If repeal is not possible, at least adopt the following changes:
    a. Have the IRS work with a group of employers to simplify the regulations so they are compatible with data systems that employers typically have.
    b. Exclude collectively bargained groups from the law as their benefits are governed under the National Labor Relations Act, and cannot be unilaterally controlled by the employer.
3. If neither of the above is possible, delay implementation of Section 89 until final regulations are published and employers have time to understand them and set up data systems to comply with them.

We have been encouraged that the complications of Section 89 have been realized, and that HR 1864 has been introduced to simplify some of the compliance requirements.

We are pleased by the following effects of HR 1864:

1. Simplifying the eligibility test; although an 80% testing factor would have been preferred to the resolution's 90% level, Simpson should pass at 90%,
2. Returning group life insurance from Section 89 to Section 79 tax treatment,
3. Redefining part-time employees as those who work 25 or more hours per week (Simpson provides coverage at 20 hours per week), and
4. Measuring plans of collectively bargained groups separately. (We are assuming the proposed law would test each bargaining unit separately. This is important given varied benefit packages negotiated on a unit by unit basis to meet local needs.)

We are very concerned about the following as affected by HR 1864:

1. The price of the health care options in a cafeteria plan, rather than the net difference between company provided funding and the price, is used in the Eligibility Test and Benefits Test,
2. Cafeteria benefit plans, salary reduction premium arrangements and medical reimbursement accounts are unfairly attacked by the proposed 133% Benefits Test,
3. The $10 per week individual and $25 per week family premium caps do not reflect geographic or plan design differences,
4. The indexed premium caps won't track with changes in the cost of medical coverage,
5. The application of the rules to prior employees (retirees) is unmanageable, and
6. The revised provision on "leased employees" in the test will still be difficult to satisfy based on limited information about these non-employees.

Here is how these areas of concern affect Simpson employees, and our suggested remedies:

Cafeteria Benefits Program Treatment

All of Simpson's 2,500 nonunion employees, whether hourly or salaried are eligible for the same benefits options under the company's cafeteria benefits program. This program includes at least three medical coverage options at each of our 29 work locations and an additional one or two health maintenance organization (HMO) options where they are available. Simpson provides each employee, by line of business, with the same amount of health care benefit dollars to spend on his or her choice of a family health care option. Any residual dollars may be taken as taxable compensation or grouped with other company-provided or salary reduction dollars to buy other benefits, such as: employee and dependent life insurance, short-term and long-term disability coverage, health care and dependent care reimbursement accounts or additional vacation.

On the face of it, Simpson's plan should easily satisfy the Eligibility Test. It appears, however, that the test will focus on the total price of the health care options within the flex plan rather than on the employee's cost after applying the company-provided benefit dollars to purchase "core medical coverage" (i.e, the net cost).

We suggest that for cafeteria benefit plans the measure should be whether the employer-provided medical funding, plus any added employee premium, is adequate to purchase "core medical coverage" within the limits of the law. Further, since the total cost of the coverage in a cafeteria plan is paid by salary reduction, that only the net cost of core coverage be considered for compliance with the $10 and $25 employee premium limits of Eligibility Test. This net cost approach most closely measures the true cost to the employee for coverage.

Benefits Test

The 133% Benefits Test is flawed by the unequal treatment of salary reduction amounts for highly compensated v.s. all other employees. As we understand the proposed test, only the highly compensated employees would have salary reduction amounts included in valuing coverage. This would be compared with the cost of medical coverage alone for all other employees.

We suggest the salary reduction amounts of all employees, not just the highly compensated, be included so the Benefits Test taxes highly compensated employees only if they use the salary reduction option to a greater extent than all other employees.

As described above, Simpson is providing all employees with the same amount of benefit dollars to spend on family health care coverage. It is sufficient to purchase "core health coverage" plus dental coverage. But, the Benefits Test as currently written creates bias against cafeteria benefits programs, salary reduction arrangements and medical care reimbursement accounts. This could be corrected if our suggestion is adopted.

Employee-Paid Premium Caps

We understand the objective of the employee-paid premium caps is to assure the availability of affordable health care. However, the long-term result of the $10 individual and $25 family caps being indexed to wage growth rather than medical coverage cost may be to reduce the levels of coverage provided. Health care cost increases have consistently been much greater than wage growth or increases in the CPI.

Simpson's cafeteria plan health care premium cost increased 22% in 1988 and 42% in 1989 while wages advanced about 4.5% each year. If the employee cost of coverage were to approach the HR 1864 limits, or if the aggregate cost of coverage gets too high, Simpson would have to consider reducing the coverage available in order to be able to continue to offer health care to its employees.

The premium caps also fail to recognize potential plan design or geographic differences in the cost of coverage.

We suggest that any caps retained in HR 1864 be expressed as a percent of premium cost, such as 33% of the cost of individual coverage and 50% of the cost of family coverage. This allows recognition of geographic medical cost differences, avoids excessive cost shift to employers and reduces the risk of mass plan design changes.

Former Employees

Applying Section 89 to retirees and other former employees is unmanageable. Simpson offers health care coverage to its nonbargaining unit retirees. About 475 are enrolled and many cover their spouse. Their retirement dates range from the early 1960's to the present. There were no highly compensated employee definitions when most of them retired. Many retired before ERISA. Neither Simpson nor its consultants have determined how the Section 89 rules can be meaningfully extended to that group.

We suggest such rules be eliminated from the proposal, or at a minimum, delayed until the first day of the plan year following the issuance of final regulations for former employees and then be applicable only to people retiring on or after the effective date.

Leased Employees

We appreciate the relaxation of the leased employee rules in HR 1864, but feel they don't go quite far enough.

Simpson does not hire "leased employees" from another organization to avoid benefit plan costs. We occasionally contract with independent logging firms, or wood chip haulers, and security guard or janitorial service companies for specific services, but we do not "lease" employees for our regular business operations.

We suggest that if "leased employees" represent less than 20% of the workforce they be excluded entirely from the tests. We do not now gather the information on "leased employees" required to conduct these tests. Obtaining statements from "leasing organizations" certifying "core medical coverage in compliance with HR 1864" would be burdensome.

We appreciate very much the opportunity to have our constructive comments on Section 89 and HR 1864 entered into the record for the May 2 Committee Hearings. Also, the Committee's efforts to simplify the Section 89 regulations are gratefully acknowledged. Simpson would be pleased to provide any further assistance and/or support to the Ways and Means Committee in these efforts.

STATEMENT OF SOUTHWESTERN BELL CORPORATION
FOR THE HOUSE WAYS AND MEANS COMMITTEE MAY 2, 1989
REGARDING H.R.1864 - PROPOSAL TO MODIFY SECTION 89

CHAIRMAN ROSTENKOWSKI, OUR APPRECIATION GOES TO YOU AND MEMBERS OF YOUR COMMITTEE FOR THE OPPORTUNITY TO SUBMIT OUR TESTIMONY. OUR APPEAL IS FOR IMMEDIATE AND EFFECTIVE RELIEF THROUGH THE PASSAGE OF LEGISLATION THAT WILL SIGNIFICANTLY SIMPLIFY NONDISCRIMINATION TESTING UNDER SECTION 89. WE APPLAUD YOUR EFFORTS WITH THE INTRODUCTION OF H.R.1864. A DESIGN BASED TEST SUCH AS THAT PROPOSED BY H.R.1864 AND THAT PROPOSED BY SENATOR PRYOR WILL ENABLE US TO DISPATCH WITH THE CUMBERSOME RULES AND TIME CONSUMING AND COSTLY ACTIVITIES OF DATA GATHERING AND TESTING.

DO NOT MISTAKE OUR SUPPORT AS AN ATTEMPT TO EXEMPT OURSELVES FROM THE NONDISCRIMINATION GOALS THAT COMPRISE THE VERY BACKBONE OF SECTION 89. RATHER, BY UTILIZING A DESIGN BASED (I.E., AN ELIGIBILITY BASED) TEST, WE ARE REQUIRED TO ASSESS THE ACTUAL AVAILABILITY OF THE PLAN TO THE NONHIGHLY COMPENSATED AS COMPARED TO THE HIGHLY COMPENSATED EMPLOYEE IN ORDER TO MAKE A FAIR AND OBJECTIVE ASSESSMENT OF OUR PLAN DESIGN. WE SUPPORT THE ELIGIBILITY BASED TEST PROPOSED BY H.R.1864.

BASED ON OUR EXPERIENCES, WE FEEL THAT SIGNIFICANT SIMPLIFICATION IS WARRANTED. SOUTHWESTERN BELL CORPORATION SUPPORTS H.R.1864 PROPOSING SIMPLIFICATION OF SECTION 89. HOWEVER, THE FOLLOWING AREAS CONTINUE TO BE OF GREAT CONCERN TO SOUTHWESTERN BELL CORPORATION:

- o THE LEASED EMPLOYEE SAFE HARBOR. IT IS EXTREMELY BURDENSOME FOR EMPLOYERS TO IDENTIFY LEASED EMPLOYEES. ADDITIONALLY, REQUIRING EMPLOYERS TO CONTACT EACH LEASING ORGANIZATION TO CERTIFY THAT THE LEASING ORGANIZATION MEETS THE MANDATORY EMPLOYEE CONTRIBUTION LIMITATIONS OF THE ELIGIBILITY TEST, IS A COSTLY AND AN EXAGGERATED MEASURE TO IMPOSE ON EMPLOYERS. EMPLOYERS SHOULD NOT BE REQUIRED TO IDENTIFY LEASED EMPLOYEES IF THEIR PLANS SATISFY THE SIMPLIFIED TEST.

- o TESTING COLLECTIVE BARGAINING UNITS SEPARATELY. MANDATORY SEPARATE TESTING OF UNION/NON-UNION PLANS WILL ADVERSELY AFFECT THE RESULTS OF MANY SALARIED PLANS.

- o TESTING FORMER EMPLOYEES. THIS WILL BE EXTREMELY DIFFICULT AND BURDENSOME TO TRACK. WE WOULD LIKE TO SEE A SAFE HARBOR PROVISION THAT ALLOWS EMPLOYERS TO DISREGARD FORMER EMPLOYEES IF THE FORMER EMPLOYEES DO NOT CONSTITUTE MORE THAN 50% OF THE EMPLOYER'S ACTIVE WORKFORCE.

- Lack of direction regarding testing of multiple levels of coverage, i.e., single, two-person, family. Because a two-tier rate structure is the only situation addressed, the introduction of a third tier (i.e., two person) will adversely affect the testing of family coverages because they will always be compared to a less generous plan that is not equitable.

  It is recommended when testing plans with multiple tiers (other than employee-only coverage), the most generous tier should be taken into account in applying the 90% test for purposes of performing the benefits test. For example, this would apply where employees with two-person coverage would be eligible for family coverage (more than two-person) if the employee had two or more dependents.

- Testing of salary reduction plans as employer contributions for the Benefits Test significantly limits the effectiveness of flexible spending accounts for most highly compensated employees.

We offer you the following experience as further substantiation of the claim that Section 89, under present law, is far too complicated, costly, and cumbersome for employers.

The administrative burden and consequent cost imposed on employers with undeniably nondiscriminatory plans (as the following example will illustrate) will only continue to erode United States tax revenues. Significant simplification is needed. Simplification should maintain the true intent of Section 89, while providing the necessary relief to those whose intent was clearly not to discriminate by virtue of their plan design.

Southwestern Bell Corporation (SBC) based in St. Louis, is an international communications corporation with approximately 65,000 employees and 26,000 retirees. Through its six principal subsidiaries, Southwestern Bell Corporation provides telephone network services, telephone equipment, cellular mobile telephone service and equipment, paging service and equipment, and directory publishing and commercial printing.

During the first quarter of this year, Southwestern Bell Corporation completed its first preliminary testing using 1988 data on its managed medical plan, that is its base plan, CustomCare, along with the 47 related Health Maintenance Organizations (HMOs). These HMO options are an alternative to the base plan, CustomCare, for eligible employees.

Prior to testing, we assumed that other than the effort and expense of data collection and compilation, Section 89 would pose no problem for CustomCare due to its nondiscriminatory plan design.

CustomCare's nondiscriminatory design features include:

- CustomCare is available to all employees (high and low paid) on the same basis. (There are no differences in eligibility, company contributions, benefit levels, etc.)
- CustomCare does not require any employee contributions by the employee or immediate family dependents, although we support the concept of employee contributions as outlined in Chairman Rostenkowski's bill H.R.1864. Also, as we completed the exercise of valuing the plans to prepare for testing, it was determined to have a higher value than the available HMO options.
- Southwestern Bell Corporation makes the same company contributions for the HMOs as it does for CustomCare. However, employees voluntarily electing an alternative HMO with a premium cost that is greater than the CustomCare company contribution are responsible for paying the difference by way of employee contributions.

CustomCare, at the time of data collection, had a participation rate of approximately 72% of all employees eligible to participate in CustomCare. This percentage was derived by dividing the total number of employees electing CustomCare by the total number of employees eligible for CustomCare. The remaining employees voluntarily elected to participate in one of the 47 HMO options.

In performing the preliminary tests, Southwestern Bell Corporation utilized the Higher Value Plan Rule in order to aggregate plans and perform the 80% Coverage Test. We recognize that there are other available testing and aggregation options, one of which now appears to be more applicable, i.e., the safe harbor Employer Cost Comparability Rule. But, the proposed regulations clarifying this rule had not been released as of the date of testing.

Southwestern Bell Corporation was able to use the 80% Coverage Test for single coverage and passed with a substantial margin. However, we were unable to apply the 90% Coverage Test and were barely able to apply the 80% Coverage Test for family coverage under the Higher Value Plan Rule as explained below.

We offer you the following test results only to establish the point that the Section 89 tests as written do not address the design or intent of a clearly nondiscriminatory plan, but rather focus on employee choice.

In applying the Higher Value Plan Rule, it was determined that Southwestern Bell Corporation's margin of passage was only 1.7%. This figure was derived by dividing the percentage of nonhighly compensated employees receiving family coverage (44.7%) under Southwestern Bell Corporation's highest valued plan by the percentage of highly compensated employees receiving family coverage (54.7%) under the same plan.

Family coverage was almost discriminatory even though all employees could have elected CustomCare at no cost. If as few as 75 highly compensated employees were to make election changes (i.e, electing CustomCare family coverage), it would have prohibited us from using the 80% Coverage Test unless we utilized an additional layer of complex aggregation rules. This assumption is based on the fact that these election changes would result in highly compensated employees acquiring family coverage. (Since there is no charge for family coverage, it is reasonable to assume that all employees [highly compensated employees and nonhighly compensated employees] with families would elect family coverage.)

This test, when applied to noncontributory plans, simply measures family composition by income level. For Southwestern Bell Corporation it seems to prove that we are "almost guilty" of failing to sponsor welfare plans which insure that nonhighly compensated employees will have families in the same proportion as highly compensated employees.

To manage this test, we would need to adjust work force composition or incomes for events such as marriage, death, divorce, childbirth, etc. This hardly seems to be the intent of welfare plan nondiscrimination rules.

The close-margin on the Higher Value Plan Rule using 1988 data may force Southwestern Bell Corporation to look toward additional aggregation and testing options such as the more burdensome three-part test in 1989, requiring costly additional data collection just to prove that an incontestably nondiscriminatory plan does not favor the highly compensated.

The aforementioned example produces another obstacle that must be taken into consideration. Using the Higher Value Plan Rule, we would have been forced to track highly compensated employee election changes during the entire plan year. This effort would include changes that result from marriage, divorce, childbirth, death, and job relocations. We fully support recent efforts both by members of Congress and groups such as the Section 89 Coalition in proposing changes to the current regulations which would require compliance on a single testing date.

To date, we have spent well over $100,000 for outside consultation, plan valuation and testing. This figure does not include our internal costs which are in excess of our external costs.

WE PROJECT THAT THESE INTERNAL AND EXTERNAL COSTS WILL BE DUPLICATED WITH OUR ONGOING EFFORTS DURING THE REMAINDER OF 1989.

THE EXPENSES INCURRED BY SOUTHWESTERN BELL CORPORATION FOR CONDUCTING THE NONDISCRIMINATION TESTS RESULT IN ADDITIONAL OPERATING EXPENSES TO THE COMPANY WHICH ULTIMATELY INCREASE THE PRICES OF OUR PRODUCTS AND SERVICES TO SOUTHWESTERN BELL CORPORATION'S CUSTOMERS. ADDITIONALLY, EXPENSES FOR CONDUCTING THE NONDISCRIMINATION TESTS ARE DEDUCTIBLE BUSINESS EXPENSES. THUS, WHERE EMPLOYERS CONDUCT NONDISCRIMINATION TESTS AND PASS, AN EROSION OF UNITED STATES TAX REVENUES IS REALIZED AS NO DISCRIMINATORY EXCESS IS IMPUTED, YET BUSINESS DEDUCTIONS ARE PERMISSIBLE.

LIKEWISE, TAX REVENUES ARE AFFECTED WHERE AN EMPLOYER CONDUCTS THE TESTS AND FAILS UNLESS THE IMPUTED INCOME AND CORRESPONDING INDIVIDUAL TAX RATES ARE GREATER THAN THE EMPLOYER'S APPLICABLE DEDUCTION.

A CLOSE EXAMINATION OF THE EMPLOYEE PROFILE REVEALED THAT SOUTHWESTERN BELL CORPORATION'S ABILITY TO AGGREGATE PLANS AND APPLY COVERAGE TESTS IS THREATENED BY TWO PRINCIPLE FACTORS:

1) DEMOGRAPHICS AND

2) EMPLOYEE VOLUNTARY SELECTION OF LESS VALUABLE OPTIONS (BASED ON THEIR PREFERENCES) EVEN THOUGH THE MOST VALUABLE OPTION IS NONCONTRIBUTORY.

THE VERY NATURE OF CUSTOMCARE'S PLAN DESIGN SUPPORTS THE ARGUMENT THAT A CLEARLY NONDISCRIMINATORY PLAN CAN BE CONSTRUED AS DISCRIMINATORY UNDER SECTION 89 METHODOLOGY BASED SOLELY ON DEMOGRAPHICS AND EMPLOYEE CHOICES.

WE APPRECIATE THE OPPORTUNITY TO EXPRESS OUR VIEWS TO YOU AND YOUR COMMITTEE. WE ARE COMMITTED, AS YOU ARE, TO THE EFFORTS DIRECTED AT SIMPLIFICATION OF SECTION 89 AND ARE, THEREFORE, AVAILABLE TO YOU OR MEMBERS OF YOUR STAFF SHOULD YOU REQUIRE ASSISTANCE IN THIS EFFORT.

STATEMENT OF KEVIN L. MEEHAN, ON BEHALF OF HIMSELF AND UNITED TECHNOLOGIES CORPORATION

HR 1864 would be an attractive alternative to the current Section 89 if it did not eliminate the ability of employers to provide real benefit choices to employees.

The bill is so worded that its effect of eliminating comprehensive flexible benefit programs is not apparent to most of the bill's sponsors. The bill provides that salary reduction contributions count as an employer-provided benefit for the highly compensated, but salary reduction contributions do not count in determining the employer-provided benefit for the non-highly compensated. But look at how salary reduction is defined!

Example: Employer A offers a medical program valued at $3,000 at no cost. No problem. Employer B offers a flexible benefit program with 3 medical plans priced at $1,000, $3,000 and $3,500. Employer B provides each employee with $3,000 in credits. From an employee's point of view salary reduction is at most the five hundred dollars the employee would have to reduce his or her salary to purchase the most expensive plan. But the Internal Revenue Service does not distinguish between salary reduction and that part of the employer contribution that can be reduced to cash. In our example, the IRS would consider the employer provided benefit to be $1,000. The benefits test would take 133% of the employer provided benefit for the non-highly compensated which in our example would be 133% of $1,000 instead of 133% of $3,000. The highly compensated employee would be taxed on the amount above $1,330!

Employers with comprehensive choice plans would have to do one of two things to make them acceptable to the higher paid. They could substantially raise the price on their minimum option and give less dollars back to those who elect the lowest option. Alternatively, employers could raise the value of their minimum option to what would typically be the medium option in most plan designs (in other words eliminate the low option). This most negatively affects working women, the fastest growing segment in the workforce over the last decade.

More than anything else the design of today's choice plans reflect the fact that women are remaining in the workforce after marriage. These women often have health care coverage through a spouse and it has been to the working couples advantage to reduce duplicate coverage and use benefit dollars for benefits such as: child care, vacation, or taxable cash. Yet the bill calls for a return to the traditional head of household with a non-working spouse benefit program without any recognition of the role of the dual wage earner couple in today's workforce.

What is more bewildering is that the bill as it affects choice plans has nothing to do with discrimination. Regardless of how the lower paid elect, higher paid individuals are to be taxed merely because the lower paid are offered choice. At United Technologies Corporation for example the lowest health care option, a plan with a high deductible, is only available to employees who already have core health care coverage. Yet merely because this plan is offered, the so called "highly compensated employee" gets smacked with taxes.

The bill favors fixed benefit programs which offer no coverage to some employees over choice benefit programs which cover all employees. With a fixed benefit plan an employee either has coverage or has not. If the employee does not pay the required contribution then there is no coverage. Many employers with fixed benefit program have a substantial number of employees with no health care coverage. The typical choice benefit program by contrast offers a level of core health coverage to all employees and yet choice plans are the plans the bill attacks.

United Technologies Corporation respectfully submits that employees who are covered under a choice plan should be taxed no more severely than those who are covered under a fixed benefit plan. At a very minimum there should be a safe harbor which provides that employees under a choice program will be taxed no more severely than under current law (Section 89). There should certainly be no penalty for offering a low coverage option to employees who have core coverage elsewhere.

In America choice should be supported not threatened.

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Office of General Counsel

May 12, 1989

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Office Building
Washington, D.C. 20515

HAND DELIVERED

Dear Mr. Leonard:

The United States Catholic Conference ("USCC") submits these comments with respect to H.R. 1864, the bill introduced by Chairman Dan Rostenkowski and others to simplify the nondiscrimination rules applicable to certain employee benefit plans under section 89 of the Internal Revenue Code of 1986 as amended ("the Code").

USCC is a nonprofit organization, exempt from federal income tax under section 501(c)(3) of the Code, whose members are all active Catholic bishops, representing nearly 200 dioceses in the United States. USCC and the dioceses of the Catholic Church in the United States are classified for purposes of the Code as churches or conventions or associations of churches. They and thousands of other Catholic organizations across the country conduct the widely-varied ministries of the Church, involving pastoral care, religious education, social welfare, youth activities, family life, services to the elderly, handicapped and homeless, health care, communications, and immigration and refugee assistance, among others. These Church ministries serve the needs of many segments of our society, with special concern for the underprivileged.

The Catholic bishops in the United States support, as a matter of social justice, the provision of just remuneration to all employees. In their 1986 pastoral message on the economy[1], the bishops stated:

> All persons . . . have a right to security in the event of sickness, unemployment, and old age. Participation in the life of the community calls for the protection of this same right to employment, as well as the right to healthful working conditions, to wages, and other benefits sufficient to provide individuals and their families with a standard of living in keeping with human dignity, and to the possibility of property ownership.[2]

Church law states that lay persons working for the Church "have a right to decent remuneration suited to their condition" and "a right that their pension, social security and health benefits be duly provided."[3]

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[1] Economic Justice for All, Pastoral Letter on Catholic Social Teaching and the U.S. Economy, National Conference of Catholic Bishops, Washington, D.C. (1986).

[2] *Id.* ¶80.

[3] Canon 231 §2, Code of Canon Law, Canon Law Society of America, Washington, D.C. (1983).

Thus, the bishops are committed to providing Church employees with ". . . the social benefits provided by responsible employers in our nation . . . ,"[4] including the provision of health care and other employee benefits on a nondiscriminatory basis. However, the requirement of *proving* compliance with current section 89 with respect to *all* the Church's ministries could siphon literally millions of dollars nationwide from such ministries, at a time when continuing cutbacks in government funding are already taxing the Church's resources and creating additional demands for its services.

USCC supports the efforts of Chairman Rostenkowski and the others to simplify the nondiscrimination rules of section 89. Nonetheless, USCC has certain concerns regarding H.R. 1864, as it relates to plans maintained by various ministries of the Catholic Church.

Church Plan Definition Fails to Reflect the Reality of Catholic Group Plans

The church plan definition as provided under current section 89(i)(4), and as proposed in section 89(e)(1) of H.R. 1864, presents practical and interpretational problems for Catholic group plans, primarily because of the way in which such plans have been and continue to be structured. Catholic group plans generally are administered at the diocesan level ("diocesan plans"). Typically, the diocese maintains a group plan, such as a group health plan, that covers its employees and the employees of parishes in the diocese, diocesan elementary and secondary schools, and other Catholic ministries associated with the diocese.

The current section 89(i)(4) definition covers plans "maintained by a church for church employees." "Church" in this context is defined by reference to sections 3121(w)(3)(A) and (B) of the Code. It would include a church, convention or association of churches, an elementary or secondary school controlled, operated, or principally supported by a church or a convention or association of churches, and a church-controlled organization that does not serve the general public, or if it serves the general public, does not receive more than 25% of its support from any combination of governmental sources or receipts from exempt services. This definition of church plan poses certain difficulties in the Catholic context.

The Internal Revenue Service's interpretation of this definition, as contained in the proposed Treasury Regulations appears to require that a plan maintained by a church cover *only* employees of church and qualified church-controlled organizations if the church plan exemption is to be claimed.[5] Unfortunately, such an interpretation would render the section 89(i)(4) exception virtually useless for most diocesan group plans, since these plans also cover employees of Catholic ministries that do not qualify as "church" within the narrow definition of section

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4/ *Id.* ¶351.

5/ Prop. Treas. Reg. §1.89(a)-1(Q/A-1(f)(1)(iii)) states:

> *Church plans*. The term "statutory employee benefit plan" does not include a plan maintained by a church (as defined in section 3121(w)(3)(A), including a qualified church-controlled organization within the meaning of section 3121(w)(3)(B)), if the plan is maintained exclusively for clergy and church employees, and their spouses and dependents.

See also Prop. Treas. Reg. §1.89(k)-1(Q/A-2(f)), 54 Fed. Reg. 9460 (March 7, 1989).

3121(w)(3). Among organizations that would be excluded are Catholic social services agencies (e.g., Catholic Charities), old age homes, child care agencies, adoption services, residential youth care facilities, day nurseries, and agencies serving the handicapped, elderly, and homeless, all of which represent traditional ministries of the Church typically not limited to members of the Catholic faith. The section 89(i)(4) definition of church plan, with its reference to section 3121(w)(3), simply does not reflect the reality of diocesan group plan coverage. This definition of church plan, with all its deficiencies, has been carried forward into section 89(e)(1) of H.R. 1864.

A church plan exemption limited by reference to section 3121(w)(3) would require diocesan bishops to make an untenable choice: either forfeit the section 89 exemption provided under the law for the entire plan or expel non-section 3121(w)(3) ministries from coverage under the diocesan plan. The latter choice is particularly repugnant, since Catholic social services agencies, homes for the aged, child care agencies, adoption services, and the like are traditional ministries of the Church. Requiring expulsion of such organizations from coverage under diocesan group plans with the concomitant redefinition of Church ministry, in the name of an otherwise laudable policy objective, seems an unnecessarily harsh result. Certainly, Congress could not have intended to draft a church plan exemption that would be inapplicable to the group plan coverage structure of this country's largest religious denomination.

The definition of church plan currently utilized in the pension area, i.e. section 414(e) of the Code, is a much more accurate reflection of the reality of the Catholic experience with respect to group plan coverage, which very closely parallels the coverage of diocesan pension plans. USCC urges that the church plan exemption under H.R. 1864 (or any other legislative proposal to amend section 89) utilize section 414(e) as the operative definition, in order to permit the Church to continue without disruption to include all of its traditional ministries in its group plan coverage.

Church Plan Exemption Should Extend To Qualification Requirements

Although H.R. 1864 would exempt church plans from the nondiscrimination requirements for group health plans, it would not exclude group plans from the qualification requirements, as is the case with existing section 89. Presumably, this H.R. 1864 cutback on the scope of the church plan exemption was unintentional. USCC urges restoration of the applicability of the church plan exemption from the qualification requirements (now set forth in section 1(b) of H.R. 1864 under proposed section 4980C(b) of the Code), and, for that purpose, urges use of the section 414(e) church plan definition for the reasons set forth above.

Requests Regarding Church Plan Exemption

On behalf of USCC and the dioceses of the Church, we request that:

1. In order for diocesan group plan coverage to continue without disruption for the employees of the traditional ministries of the Church, the section 414(e) definition of church plan be used in the contemplated exemption from the nondiscrimination requirements of section 89; and

2. That such church plan exemption be extended to exempt church plans from the qualification requirements of proposed section 4980C(b) of the Code, as contained in section 1(b)(1) of H.R. 1864.

We look forward to meeting with you to discuss our concerns, and would be pleased to prepare appropriate draft amendments to H.R. 1864, reflecting the section 414(e) church plan definition.

Respectfully submitted,

Mark E. Chopko

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State of Wisconsin \ DEPARTMENT OF EMPLOYE TRUST FUNDS

Gary I. Gates
Secretary
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P.O. BOX 7931
MADISON, WISCONSIN 53707

May 1, 1989

IN REPLY REFER TO:

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

On behalf of the Wisconsin Department of Employe Trust Funds, I write to submit our written statement in lieu of a personal appearance to testify about H.R. 1864, a bill to simplify the nondiscrimination rules applicable to employee benefit plans under Section 89 of the Internal Revenue Code.

Generally, the Department of Employe Trust Funds, which is the state's public employee benefit and public pension plan administrator for all state and almost all local government employees, strongly supports appropriate efforts to simplify Section 89. We recognize the purposes of this law. Unfortunately, we find that the present Section 89 and the Internal Revenue Service's recently proposed regulations as they apply to state government are limited in scope and raise many more complex issues than these regulations clarify about the application of Section 89. Several state employees have already concentrated several hundred hours to study and begin to understand this legislation at significant cost, and we have much more to do. When the deadlines arrive for the state to act under this law, we expect to make reasonable, but uncertain judgments with our fingers crossed about the state's approximately 53,000 present employees and 14,000 former employees who are covered under approximately 3400 health plans and a few hundred life insurance plans based on Section 89 definitions. We believe our health and life insurance system is inherently nondiscriminatory. Because of the character of our system and because of the possible significant tax consequences to our dedicated employees resulting from any judgment errors we may make under this very complex and unclear law, we request your help.

The state of Wisconsin is a large public employer. As a single employer the state consists of the legislative, the executive, and the judicial branches. These include the legislature itself; the executive, which includes approximately 62 state agencies, and the University of Wisconsin system, which consists of the University of Wisconsin-Madison, 12 other four year campuses, and 13 two year campuses; and the judiciary, which includes the supreme court, four courts of appeals, and 209 trial courts of record. These institutions rely on more than 53,000 persons who for the most part work in the cities of Madison and Milwaukee and the rest, in the 70 other counties around the state.

Serving State and Local Government Employers and Employes by Administration of Retirement, Disability, Survivor and Health Care Plans and Social Security Coverage.

These dedicated employees receive health insurance coverage under what we believe total approximately 3400 health plans, life insurance under several hundred life insurance plans, and for the University of Wisconsin system, several other benefit plans unique to the university's special circumstances.

The Wisconsin Legislature requires the state to provide substantially equivalent medical and hospital health benefits and life insurance benefits to all its eligible employees. The Legislature delegates to the state's Group Insurance Board the authority to implement these benefits. The Group Insurance Board includes the governor, the attorney general, the secretary of the Department of Employment Relations, and the commissioner of insurance, or their designees, and five other persons who participate in the system including a teacher, a nonteacher, a local government employee, a retiree, and another whom the governor appoints. The Board basically establishes comparable health benefits under the state's indemnity plan and its numerous HMOs at relatively similar costs and offers to all eligible employees any one of these plans under the same terms and conditions without any regard to the employee's salary level. The Group Insurance Board similarly implements the state's life insurance program. In each case, the Board offers these plans consistent with any applicable federal laws. The Department of Employe Trust Funds administers these benefit programs as a public trust. Secs. 40.01, 40.51, 40.52, and 40.70, Wis. Stats.

We support the efforts of Representatives Dan Rostenkowski and Thomas Foley and their colleagues to simplify Section 89 in their proposal now before the Committee on Ways and Means. While we believe their reasonable approach moves Section 89 in the right direction, we think they do not do enough to recognize the inherently nondiscriminatory character of some public employer benefit plans such as Wisconsin's plans. We do not propose that the Committee on Ways and Means and the Congress exempt governmental plans from Section 89. Rather, we propose that this Committee and the Congress recognize in Section 89 that the public employer benefit plans that a legislature mandates are inherently nondiscriminatory because the legislative process with its competing interests virtually assures that all public employees, regardless of their position and compensation, receive comparable health and life insurance coverage.

We therefore respectfully urge the creation in Section 89 of a presumption for large public employers to recognize the inherently nondiscriminatory character of such public benefit plans. We recommend the establishment of a conclusive presumption that the health and life insurance plans of any public employer employing more than 5,000 active employees are nondiscriminatory when a legislature either itself or through a government agency requires a public employer to make available to all active employees their choice of any one of two or more of all available plans on the same terms and conditions without any regard to the employee's compensation. We think such presumption would recognize both the Congress's interests under Section 89 and, at the same time, the large public employers' interests in their unique employer circumstances where a legislature requires an employer to offer such comparable health and life insurance benefits to all employees on the same terms and conditions without regard to any employee's compensation. Moreover, we view such presumption as a rule that may encourage similar government employers to establish such inherently nondiscriminatory health and life insurance plans. The Department believes this is good public policy consistent with Section 89 that goes beyond the technical requirements of this law. We respectfully urge you to consider very seriously adopting such a proposal.

We are forwarding a copy of our letter to U.S. Senators Bob Kasten, (R., Wis.) and Herbert Kohl, (D., Wis.); Committee on Ways and Means Member Rep. Jim Moody, (D., Wis.) and the other members of the Wisconsin congressional delegation; Wisconsin Governor Tommy G. Thompson, and the state's legislative leaders.

If you have any questions, please contact us.

Thank you for your consideration.

Sincerely,

Kevin B. Cronin
Chief Counsel

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